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In the Supreme Court of the United States

OCTOBER TERM, 1958

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

The Solicitor General, on behalf of the Securities and Exchange Commission, prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the District of Columbia Circuit, entered May 22, 1958, which affirmed the judgment entered on September 30, 1957 by the United States District Court for the District of Columbia.

OPINIONS BELOW

The opinion of the Court of Appeals (App. A, *infra*, pp. 21–30) is not yet reported. The opinion of the District Court (R. 82) is reported at 155 F. Supp. 521.

JURISDICTION

The judgment of the Court of Appeals was entered on May 22, 1958 (App. A, *infra*, pp. 30–31). The jurisdiction of this Court is invoked under 28 U. S. C. 1254 (1) which is made applicable by Section 22 (a) of the Securities Act of 1933 (15 U. S. C. 77v (a)) and Section 44 of the Investment Company Act of 1940 (15 U. S. C. 80a–43).

QUESTION PRESENTED

Whether a company which sells to the public its "deferred variable annuity policies," under which the purchaser receives an interest representing pro rata shares in the company's portfolio of securities and in the gains and losses therefrom, is required (a) to register those contracts pursuant to the Securities Act of 1933 and (b) to register as an investment company pursuant to the Investment Company Act of 1940; or whether exemptions in these Acts relating to annuities and to companies engaged in the business of writing insurance are available to the company.

STATUTES INVOLVED

The relevant statutory provisions of the Securities Act of 1933 (15 U. S. C. 77a), the Investment Company Act of 1940 (15 U. S. C. 80a), and the McCarran-Ferguson Insurance Regulation Act (15 U. S. C. 1011) are set forth in Appendix B, *infra*, pp. 32–37.

STATEMENT

This action was instituted by the Securities and Exchange Commission to enjoin the Variable Annuity

Life Insurance Company of America ("VALIC") from (a) offering and selling securities in violation of the registration requirements of Section 5 of the Securities Act of 1933 (15 U. S. C. 77e) and from (b) engaging in enumerated activities set forth in Section 7 of the Investment Company Act of 1940 (15 U. S. C. 80a–7), until registered as an investment company under Section 8 of that Act (15 U. S. C. 80a–8). The Equity Annuity Life Insurance Company ("EALIC") and the National Association of Securities Dealers, Inc. were granted leave to intervene as party defendant and party plaintiff, respectively.[1]

The respondents have been offering and selling what they describe as "Variable Annuities". They are chartered as insurance companies by the District of Columbia Department of Insurance and the particular contracts have been approved for sale as annuity contracts. The Securities and Exchange Commission contends that the interests are investment contracts, nonexempt securities. It was on this premise that the Commission instituted injunction proceedings.

Of several different types of contracts offered by respondents, the one which has been used by the lower courts as illustrative of the pertinent characteristics of these contracts is the "Deferred Variable Annuity." Under the terms of that contract, the purchaser, referred to in the contract as the "policy holder," promises to pay to the company a fixed sum of money, usually at specified periodic intervals, which the com-

[1] A petition for certiorari has been filed by the National Association of Securities Dealers, Inc., No. 237, this Term.

pany promises to pool with monies received from other purchasers and to invest in a portfolio of common stocks after having made certain specified deductions.[2] This portfolio is administered by respondents and common stocks are bought and sold in accordance with the investment judgment of their managements.[3] As payments are made, securities are acquired for the portfolio. In return for the money invested, the purchaser is credited with a certain number of "accumulation units." These units represent the purchaser's "aliquot" or undivided interest in the portfolio of securities purchased with his money (see Finding of Fact 45, R. 107), and therefore his interest fluctuates in direct relation to the value of the securities portfolio. During the period the purchaser makes payments the contract provides that he may at any time make prepayments, thus acquiring units at a more rapid rate than is provided in the contract. Or he may liquidate and withdraw all or a portion of his units.[4] In that event he receives a sum equal to

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[2] The loading charges per year are:
1st year, 52% of the amount invested.
2nd through 5th year, 12% of the amount invested.
6th through 10th year, 11% of the amount invested.
11th and thereafter, 8% of the amount invested.
In addition, the contract provides for a company management fee of 1.8% per annum on investments.

[3] Sales literature of EALIC, for example, states: "You avoid buying stocks on a 'hot tip.' Instead you benefit from the counsel of expert financial advisers; the Company purchases stocks upon the recommendation of The First National City Bank of New York. In short, you get the benefit of expert diversification." (Pl. Ex. 17.)

[4] By prepurchasing or by partially withdrawing units the purchaser may speculate upon the short term fortunes of the

the then value of the proportionate share of the fund's assets represented by the units redeemed. If he withdraws all of his units during the first five years of the contract, the company charges a penalty (see Findings of Fact 47, and 50, R. 107, 108).

After the maturity date, a date which has been preselected by the investor, presumably as the date on which he intends to retire, the purchaser is entitled to receive a series of monthly payments of fluctuating sums representing the then value of a fixed number of annuity units, which, like the accumulation units, represent an "aliquot" share of the portfolio of the securities of the fund (see Finding of Fact 70, R. 109). The number of "annuity units" comprising the monthly payment received by the purchaser is derived from the dollar value of the "accumulation units" at the maturity date, *i. e.*, the dollar value of the first monthly payment is calculated by reference to an annuity table and this is translated into the number of "annuity units." These payments continue

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company's portfolio. If he purchases units in advance, he gains if they increase in value before the time when he would have normally purchased them under the contract. If he withdraws part of his units, he gains if the units decrease in value at the time he repurchases them.

The purchaser may make a partial withdrawal of his units by getting what is termed a "policy loan." In this transaction, he "borrows" from the company the value of a number of units and the number of units credited to him is reduced by that number. When he repays the "loan," units are replaced at their then current value. Thus he may replace more or less units than he borrowed when he repays the money, depending on the interim fluctuations in the value of the portfolio.

for the rest of the purchasers life,[5] and during this period he may no longer exercise the withdrawal privilege.

The purchaser's interest thus fluctuates at all times in direct relationship to the changes in the market value of the portfolio securities and other assets of the fund (see Finding of Fact 46, R. 107). Prior to the maturity date, the value of the purchaser's interest reflects solely his investments, any income applicable thereto, and any profit or loss thereon. After the maturity date, the amount of the company's monthly payments to the purchaser continues to reflect all of these factors. At no time is any portion of the purchaser's risk of profit or loss borne by the company (Finding of Fact 49, R. 108).

The District Court denied the injunction, holding that, although "the logic of the law seems to bring the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants within the terms and plan of the Investment Company Act," federal regulation is precluded by the McCarran-Ferguson Act (R. 89). The District Court indicated that that Act was applicable because the respondents had been "chartered as insurance companies by the District of Columbia and their questioned contracts had been approved by the Insurance Superintendent of the District, and by the insurance

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[5] After the institution of the Commission's action against VALIC, it ceased offering contracts providing an option for payment over a fixed term of years with no mortality feature (Pl. Ex. 6-A-1, P. 3). However, investors who had entered into those arrangements are continuing to purchase accumulation units thereunder.

departments of certain states" (R. 90). The court said that if the respondents had not been

> chartered, licensed and regulated by the District and state authorities and if Congress had not passed the McCarran Act, the questions raised by SEC would be answered by applying the rules of statutory construction to the Securities Act of 1933 and the Investment Company Act of 1940, and, in the opinion of this court, such construction would bring the defendants within the purview and purposes of those statutes. [R. 90.]

The Court of Appeals affirmed the holding of the District Court, but, in contrast to the ground for decision adopted in that court, it ruled that the contracts are within the exemptions provided by the securities laws for insurance. It stated that "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance."

REASONS FOR GRANTING THE WRIT

1. The variable annuity is a novel type of contract which attempts to meet an important economic problem—*i. e.*, how an individual may by regular investment create a fund to provide adequately for his years of retirement in the face of a possible rise in the cost of living. If, as claimed by its proponents, it meets this need, it is likely that it will have a widespread acceptance among public investors. The Securities and Exchange Commission has no desire to prevent economic experimentation of this sort; in fact, much of the activity regulated by the Commis-

sion has traditionally been aimed at meeting various problems of inflation. The Commission is concerned, however, that under the decision below persons investing in variable annuities will be deprived of protections generally accorded investors by the Securities Act of 1933 and the Investment Company Act of 1940. These protections include full disclosure of all relevant information concerning securities registered with the Commission under the Securities Act, and regulation of various activities of the issuer flowing from registration under the Investment Company Act, including in this latter connection requirements as to definitive recitals of investment policy, the prohibition against changing such policy without approval of investors, and restrictions upon dealings between a company and its insiders.

It is the Commission's position that the activity involved under the variable annuity contract—*i. e.*, the placing of capital with a company for investment in common stock with a view to profit solely from the company's management of the investor's money, the pooling of the capital of many investors by the company, and the acceptance by the investors of all risks of market fluctuations—was intended to be regulated by the Congress under the federal securities laws.

Both opinions below recognize that the variable annuity provides an opportunity for an investor to increase his capital by investing it with the expectation that the efforts of the management will result in profit to the investor. This profit-seeking feature pervades all aspects of the contract because its claimed economic function of protecting against inflation by

an annuity cannot be realized without these profits. And it is this opportunity for profit resulting from the efforts of others which dictates the conclusion that the contract involved is a non-exempt security under the Securities Act, for the courts have repeatedly brushed aside the formal trappings of an instrument to hold that a contract involving investment risk is a security no matter how the issuer attempts to disguise it. This Court, for example, has twice ruled that a contract, the basic purpose of which is investment, is a security regardless of the form it takes. *S. E. C.* v. *W. J. Howey Co.*, 328 U. S. 293, and *S. E. C.* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344.

Respondents' contracts and operations are in most respects similar to those of the usual mutual fund or open-end investment company registered with the Commission under the Investment Company Act of 1940. These companies sell a substantial portion of their shares under periodic accumulation arrangements,[6] which are essentially identical to the variable annuity during the most extensive period of the variable annuity contract, the accumulation period prior to maturity. The shares sold under these periodic accumulation plans, like the variable annuity contracts, represent an aliquot interest in a portfolio of securities, usually equity securities. As with the variable annuity, the periodic accumulation plans provide that the investors pay a specified sum of money

[6] While exact information is not available, the dollar amount has been estimated at approximately $1,028,000,000 at June 30, 1958. *Statistical Bulletin*, National Association of Investment Companies, June 30, 1958.

at periodic intervals. In the variable annuity and in the investment company plans, this money, after certain specified deductions are made, is invested in securities to be added to the company's portfolio. Under the periodic accumulation plans, in return for the money invested, the investor is credited with a number of shares in a manner like that followed by respondents.[7] At any time during the life of a periodic plan, moreover, the investor may stop buying shares, may partially liquidate his shares, may totally liquidate his holdings, or may purchase shares at a date prior to the time called for in the contract. These opportunities are the same as those available to the variable annuity purchaser during the pay-in period.

Although the respondents' contracts use insurance parlance, the basic economic factors differ substantially from those relating to insurance companies. An insurance company has to meet fixed obligations and, in the case of a stock company, will be insolvent if its investment policy is such that the insurance obligations cannot be met. Therefore, there is great economic pressure to invest conservatively. Respondents, however, are under no such pressure, since payment on variable annuities is made without reference to fixed dollar obligations. It is true that increased sales with resulting profits to the company would result from successful operation, but the chance

[7] As in the variable annuity, the investor usually receives only a notification of how many shares he owns but does not receive actual share certificates although he may demand them at any time.

of spectacular success through speculative investment policies might sometimes outweigh considerations of safety.[8] Disclosure, particularly of investment objectives and of changes in policy, as required by the federal securities acts, is therefore important to investor protection.

Although the Commission makes no charge in this action with respect to the nature of respondents' investment policies, there are certain other practices currently engaged in by respondents which, under the securities laws, would clearly be prohibited. For example, under Section 27 (a) (1) of the Investment Company Act of 1940 registered investment companies issuing periodic payment plan certificates may charge no more than "9 per centum of the total payments to be made thereon." Both respondents charge a higher percentage. Under Section 27 (a) (2) of the Investment Company Act such registered investment companies may charge as sales load no more than "one-half of any of the first twelve monthly payments" received from investors. Both respond-

[8] Indeed, there could conceivably be pressure to have the dollar value of the unit go down. Although the life-expectancy tables presently used by the companies reflect anticipated increases in longevity, if, due to a dramatic medical discovery, these expectations should be exceeded, and the life span substantially increased, the company would be required to pay out the value of a greater number of units than originally estimated to the detriment of its stockholders. In order to reduce this unexpected expense, it would be advantageous to the company to reduce the dollar value of the units. This could be done by following an investment policy wholly contrary to the interest of the investors or even by failing to invest funds, since the annual management fee of 1.8% applies to cash as well as securities and an additional annual 3.5% deduction is made on all annuity units.

ents charge in excess of this percentage. The sales literature of each respondent, moreover, fails to conform in many respects to a Statement of Policy, adopted by the Commission,[9] which enumerates certain practices with respect to sales literature of investment companies that the Commission believes are "false and misleading." The Statement of Policy was adopted after compresensive studies of sales literature used in the sale of investment company shares and after opportunity to all persons to comment on drafts thereof, and was revised in the light of subsequent experience. It sets forth standards with respect to claims made on such matters as the rates of return on the investor's capital, the safety of his capital, the effect of government supervision on the management of the company, the benefits of dollar averaging and continuous investment, and the amount of the commissions charged. It prohibits the use of reprints from articles relating to the whole investment company industry and restricts the use of charts using information based on market indices. No attempt is made in the sales literature of respondents (R. 745–804) to conform to the standards set forth in the Statement of Policy. For example, each respondent refers in its sales literature to the value of an assumed investment over the past twenty years, based not upon the experience of the company but upon some stock market average of securities differing substantially from the company's current portfolio, and each respondent uses charts and graphs

[9] Investment Company Act Release No. 2621 (1955).

based upon these averages. These comparisons, without certain affirmative disclosures which respondents failed to make, as well as the charts and graphs based thereon, clearly contravene the Statement of Policy. VALIC, indeed, goes so far as to refer to its contracts as "INFLATION PROOF ANNUITIES" (R. 761)—a reference which would appear to be in gross violation of the full disclosure requirements of the Securities Act.

2. Both courts below, in reaching the result that the contracts here involved are not subject to regulation by the Securities and Exchange Commission, placed great emphasis on the fact that these contracts are regulated as insurance by local commissioners. This emphasis is misplaced, will result in much litigation and confusion, and will hamper effective enforcement by the Securities and Exchange Commission of the statutes subject to its administration.

The fact that local insurance commissions have regulated these companies and approved their contracts is not at all controlling. The statutory scheme is different from that involved in *Alleghany Corporation* v. *Breswick and Co.*, 353 U. S. 151, where, by specific provision of law, regulation by another body (the Interstate Commerce Commission) was the basis for an exemption. Here, on the contrary, both the Securities Act (15 U. S. C. 77r) and the Investment Company Act (15 U. S. C. 80a–49) provide that there may be concurrent regulation by the Securities and Exchange Commission and state commissions. For this purpose, it makes no difference whether individual states choose to exercise

supervision over particular securities through their insurance commissioners rather than their securities commissions. So long as the securities are not in fact insurance, the federal Commission is endowed with power under its legislation.

To be sure, regulation of the issuing company by an insurance commissioner is one condition precedent to the exemption of insurance or annuity contracts from the federal Commission's jurisdiction.[10] But it still must be found that insurance or annuity contracts are really involved, and the federal legislation does not refer that determination to the local authorities, but vests it in the federal courts. The state authority's determination that the contracts are in the nature of insurance or annuities is significant only so far as it helps in determining what they are in fact. Whatever evidentiary weight may be given to such a local determination, it cannot be conclusive on the federal

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[10] The exemption under Section 3 (a) (8) of the Securities Act requires first a determination that the instrument involved is an "insurance or endowment policy or annuity contract or optional annuity contract" and then, as an additional qualification, that it be "issued by a corporation subject to the supervision of the insurance commissioner * * *." Similarly, an insurance company exempted from the Investment Company Act must, under Section 2 (a) (17), be first determined to be a "company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies * * *," and additionally that the company be "subject to supervision by the insurance commissioner." The Investment Company Act specifically contemplates dual regulation by an insurance commissioner and the Securities and Exchange Commission in the situation where an investment company sells insurance policies. 15 U. S. C. 80a-24 (d).

agency. Similarly, the McCarran-Ferguson Act (App. B, *infra*, pp. 36–37) is not applicable because it does not purport to refer the question of what is "insurance" to the states; that Act comes into operation only after it has been decided that the "business of insurance" is involved.[11]

The issue here is simply one of determining the meaning intended by Congress in using the words "insurance" and "annuity" in the Securities and Investment Company Acts. We contend, for the reasons summarized above, that respondents' contracts are not such "insurance" or "annuities". We also suggest that in resolving this question the courts should give weight to the interpretation adopted by the Securities and Exchange Commission, the agency set up by Congress to administer the federal statutes.[12] The confusion and litigation that will flow from relying on the determinations of individual state commissioners is indicated by the results of a poll of thirty-seven states made in 1957 by the National Association of Securities Administrators to the effect that insurance commissioners are about evenly split on the

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[11] For this reason, the recent case of *Federal Trade Commission* v. *National Casualty Co.*, Oct. Term 1957, No. 435, decided June 30, 1958, has no present bearing. There, the question was the extent to which Congress ceded power to the states to regulate activities which patently and admittedly related to insurance. No issue was raised as to whether what was being regulated was in fact insurance.

[12] *S. E. C.* v. *Associated Gas & Electric Co.*, 99 F. 2d 795 (C. A. 2); cf. *United States* v. *Allen-Bradley Co.*, 352 U. S. 306; *N. L. R. B.* v. *Denver Building Council*, 341 U. S. 675; *United States* v. *American Trucking Associations, Inc.*, 310 U. S. 534.

question whether or not to approve the variable annuity for sale as insurance, while the securities commissioners are almost unanimous in their opinion that the variable annuity is a security.[13] In West Virginia, both the insurance commissioner and the securities commissioner are attempting to exercise their jurisdiction over the VALIC contracts.[14]

Ultimately, many of the determinations of state commissioners will probably be reviewed by state courts,[15] although to date there has been only one state court that has passed upon a contract substantially identical to the variable annuity.[16] The Supreme

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[13] 1 C. C. H. Blue Sky Rep. Para. 4711.

[14] See fn. 16, *infra*.

[15] See *State* v. *Towle*, 80 Me. 287, 14 Atl. 195, where the court said:

"*It does not seem probable that the legislature intended to commit to the care of the commissioner the business of illegal or illegitimate insurance companies.* It would be tolerating instead of condemning them. He has the power to issue and suspend licenses. But there must be cause for either act. * * * His business is to deal with such companies as can, when licensed, issue legal policies. *His act cannot confer legality upon companies doing illegal business.*" (Emphasis added.)

See also *Jordan* v. *Group Health Association*, 107 F. 2d 239 (C. A. D. C.).

[16] An "Estate Builder" contract, having certain features of the variable annuity contract and using insurance terminology was held to be an attempt to sell an investment as insurance in *Coastal States Life Insurance Company* v. *Kelly*, Court of Common Pleas, Richland County, So. Car., June 1955, unreported.

On July 21 and 22, 1958, there was a trial in West Virginia on a complaint for injunction instituted by the Securities Commissioner of that State to prevent VALIC from selling their contracts in violation of the securities laws of West Virginia. No decision has been rendered in that action as yet. *State of West Virginia* v. *Variable Annuity Life Insurance Co.*, Circuit Court of Kanawha County, W. Va., Docket No. 24, 449.

Court of Errors of Connecticut in *Spellacy* v. *The American Life Insurance Association,* 144 Conn. 346, 131 A. 2d 834, dealt with a "variable endowment" contract with a "variable annuity" option at the maturity date. That contract provides for investment by the company in a pool of equity securities. The purchaser's interest in the fund is represented by units which fluctuate in value in accordance with the investment experience of the fund, and upon maturity the purchaser may at his option become entitled to a periodic payment of units of fluctuating value during the remainder of his lifetime. The Connecticut court held that the contract was not an insurance or an annuity policy within the meaning of the term in the Connecticut General Statutes and as these terms are generally used and understood.

The court below, in holding that there was no jurisdiction in the Securities and Exchange Commission over variable annuities, was considering only the contract sold in the District of Columbia and approved for sale as insurance by its insurance commissioner. However, where state insurance commissioners have forbidden the sale of this contract as insurance or where there is internal conflict in the state, the court's opinion does not necessarily preclude regulation by this Commission. Thus, in the vast majority of states there is uncertainty as to the extent of the Commission's jurisdiction over variable annuities.[17]

[17] This result is hardly consistent with the nationwide protection of investors contemplated by Congress when the securities acts were adopted. See *e. g.*, Section 1 (a) (5) of the

Moreover, by reason of the McCarran-Ferguson Act this uncertainty may relate not only to the regulation by this Commission but also to the application to these companies of federal regulatory statutes not administered by this Commission, *e. g.*, the Federal Trade Commission Act.

3. Finally, in the area of investment company regulation there arises the question whether under the ruling of the court below companies now subject to regulation will be able to oust the Securities and Exchange Commission of currently exercised jurisdiction.

As noted above, the variable annuity during the pay-in period is virtually identical to the periodic purchase of mutual fund shares. It would be a simple matter for persons managing investment companies to add to a periodic accumulation plan an "annuity" provision which, being optional, would presumably elicit no objections from investors and thus enable the mutual fund to escape the jurisdiction of this Commission. Whether the investment companies would be required to comply with some type of insurance regulation, if they sought to change their operation to sell the variable annuity, is not clear and might vary from state to state, but it is clear that the change in the nature of their business would be minuscule.

Investment Company Act (15 U. S. C. 80a–1 (a) (5)) where it was declared that investment companies are affected with a national public interest because, among other reasons, the activities of such companies "extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors."

The size of the problem is demonstrated by the fact that open-end investment companies registered under the Investment Company Act of 1940, whose operations need only minor alterations in order to engage in the sale of variable annuity contracts, hold aggregate assets of nearly $10 billion and attract the capital of public investors at the rate of approximately $1 billion a year.

We have already indicated that, in view of the claimed ability of this contract to protect an investor against inflation, it is probable that this or some other type of investment contract payable over the period of a person's life will become a most important economic device. It is possible that a substantial proportion of the sales of annuities may be switched to the variable annuities. It is, therefore, of utmost importance to determine whether the contracts and those companies which sell the contracts are to be regulated by state insurance authority, by the Securities and Exchange Commission, or by both.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

J. LEE RANKIN,
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Securities and Exchange Commission.
AUGUST 1958.

APPENDIX A

United States Court of Appeals for the District of Columbia

No. 14,253

SECURITIES AND EXCHANGE COMMISSION, APPELLANT

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, INC., and
EQUITY ANNUITY LIFE INSURANCE COMPANY, APPELLEES

No. 14,254

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., APPELLANT

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, INC., and
EQUITY ANNUITY LIFE INSURANCE COMPANY, APPELLEES

Appeals from the United States District Court for the District of Columbia

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Decided May 22, 1958

Before WILBUR K. MILLER and DANAHER, *Circuit Judges,* and MADDEN, *Judge,* United States Court of Claims.*

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*Sitting by designation pursuant to provisions of Sec. 291 (a), Title 28, U. S. Code.

MADDEN, *Judge:* Securities and Exchange Commission, (SEC), brought suit in the District Court seeking an injunction restraining Variable Annuity Life Insurance Company of America, Inc. (VALIC), from selling or offering for sale certain contracts or policies unless and until the contracts or policies were registered with SEC in accordance with section 5 of the Securities Act of 1933, 48 Stat. 74, 77, 15 U. S. C. § 77 (e), and unless VALIC complied with section 7 (a) of the Investment Company Act of 1940, 54 Stat. 789, 802, 15 U. S. C. § 80a–7 (a). On their own motions the National Association of Securities Dealers (NASD), and the Equity Annuity Life Insurance Company (EALIC), intervened on the sides of the plaintiff and the defendant, respectively.

The District Court dismissed the complaint, and the plaintiffs have appealed from that judgment. The original defendant and the intervening defendant sell the same kinds of contracts or policies. Those of VALIC will be discussed in this opinion.

The appellees contend that the contracts which they sell and which are the subject of this controversy are annuity policies and are therefore covered by the law relating to insurance, and not by the law relating to securities. They point to section 3 (a) (8) of the Securities Act of 1933, 15 U. S. C. § 77 (c) (a) (8) which says:

> SEC. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> * * * * *
>
> (8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any

> agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

They point to section 3 (c) (3) of the Investment Company Act of 1940, 15 U. S. C. § 80a–3 (c) (3), which says that an insurance company is not an investment company within the meaning of the Act, and to section 2 (a) (17) of that Act, 15 U. S. C. § 80a–2 (a) (17) which says:

> (a) When used in this title, unless the context otherwise requires—
>
> * * * * *
>
> (17) "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

They point to the McCarran-Ferguson Insurance Regulation Act of March 9, 1945, 59 Stat. 33; 15 U. S. C. §§ 1011–1015, which says:

> * * * That the Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.
>
> SEC. 2. (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after January 1, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

* * * * *

SEC. 5. As used in this Act, the term "State" includes the several States, Alaska, Hawaii, Puerto Rico, and the District of Columbia.

Although VALIC sells what are undoubtedly life insurance contracts, they are tied in with its "annuity" contracts, and are a small part of its total business. If its "annuity" contracts are not annuity contracts within the meaning of the word annuity in the Securities Act of 1933, and within the contemplated business of insurance as that word is used in the Investment Company Act and the McCarran-Ferguson Act, the "annuity" label which VALIC places upon its contracts will not avail it.

We lay aside the life insurance feature of the policies, and discuss the annuity feature. In fact, as we understand it, if the applicant for an annuity policy is insurable, for life insurance purposes, he must take at least a five year term life insurance policy. That seems to us to be irrelevant to the question of the nature of the predominant annuity feature of the policy. We will therefore discuss a naked

deferred annuity policy such as would be issued by VALIC to one uninsurable for life insurance purposes.

The policy holder agrees to pay a fixed sum of money per year for each year until he reaches the age when his deferred annuity will begin to pay out. A considerable part of what he pays for the first year, and a smaller part of what he pays thereafter are taken by the company for selling and administrative expense and profit. The rest is invested, at the discretion of the company, in securities which, it is hoped, will produce an income or show a capital gain or both. The policy holder is given periodic statements showing what the company has bought with what he and the other policy holders have paid in. These are statements of his "accumulation units." If, for example, the common stocks which the company held at the time the policy holder paid his annual premium were cheap, he would acquire, for the dollars he paid in, a larger number of "accumulation units", since the price or value of the "accumulation units" would be determined by dividing the value of the company's holdings by the number of the units. If thereafter the value of the company's holdings increased, the policy holder would still have the same number of units, but the value of each unit would be higher. If the value of the holdings decreased, the result would, of course, be the opposite.

Throughout the paying-in period, the value of the policy holders' accumulations would fluctuate with the price of the securities in which the company invested its funds. The policy holder would hope that the long run trend of the prices would be upward. If so, "accumulation units" which he acquired in the early years for $1.00 might be worth $1.50 or $2.00 by the time his deferred annuity came due.

When the time comes for the company to begin to pay the deferred annuity, the policy holder acquires no more "accumulation units" since he will pay no more premiums. The number of "accumulation units" which he has acquired during the years of his payment of premiums will be multiplied by the then value of an accumulation unit, and that dollar amount will be the amount upon which his annuity will be computed. Using the mortality table appropriate to his age and sex, and assuming that 3½ percent interest can be earned upon the funds of the company until they are paid out, the dollar amount, per month, of his annuity is determined, and he is paid that amount for one month. The payments thereafter are determined according to the success of the company with its investments, and may be smaller or larger than the first month's payment. If the value of the "accumulation units", the number of which was fixed when the premium payments stopped, increases, the annuity payments will increase at that time to what they would have been if the units had had that value at the time the first month's annuity had been computed.

The arrangement is, of course, novel. It has been invented in an attempt to obviate the lack of reality of the traditional life insurance and annuity policy in relation to the value of the dollar. Annuity policies bought to provide a living in his latter years for the policy-holder annuitant, and life insurance policies bought to provide for the families of deceased policy holders have proved inadequate because of the decline of the value of the dollar in terms of purchasing power. Persons who have paid for life insurance or annuities have wished that they had bought, instead, tangible things or equities which would have, or might have, kept pace with the inflation of prices. There

was room and need for experimentation in an effort to meet this serious problem. The contracts or "policies" offered by VALIC are an experiment in that direction. The question in this litigation is whether these contracts are "insurance" contracts, within the meaning of the statutes quoted above.

The Superintendent of Insurance of the District of Columbia, after due inquiry, issued to VALIC a certificate of authority "to transact within the District of Columbia the business of Life Insurance and Variable Annuities." Insurance Commissioners of three other States have issued similar licenses. The opinion of these officials, charged with the task of careful supervision of the business of insurance to protect the public from imposition, that the business of VALIC is the business of insurance, is important.

Elements of similarity between the "variable annuity" here in question and the traditional annuity may be noted. Both provide that the policy holder may elect at what time between certain stated ages, such as 50 and 70, the annuity payments are to begin. Both provide that the policy holder may cash in the value of his annuity before annuity payments begin. Both provide a loan value for the annuity contract. Both provide for the payment to beneficiaries in case of the death of the annuitant before annuity payments begin. Both provide that if the policy holder ceases paying premiums, a reduced annuity is nevertheless acquired for the payments he has made. Both provide options whereby payments may continue to another beneficiary after the death of the principal annuitant, and other options. Both have provisions making the annuity payments exempt from the claims of creditors.

It is apparent that the VALIC contract bears many resemblances to a conventional annuity policy. The

appellants say that these resemblances are superficial; that the identifying quality of insurance is risk-shifting, and that in the VALIC contracts the policy holder bears his own risk, the risk that the company's investments of his premiums will increase or decrease in value. But perhaps the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last. If everyone died on the day set for him by the mortality tables, there would be no point in paying an insurance company for doling out one's funds. A savings account, or Government or municipal or good corporate bonds, or a simple trust would do as well. VALIC, by the fact of issuing an annuity policy, does assume the risk of when the annuitant will die. If it does not bear the risk itself, it provides the machinery whereby the risk is shifted from the individual to the group of policy holders.

The appellants urge that VALIC policy holders, like investors in investment companies, may lose their savings and ultimately fail to receive the protection which they hoped to buy when they paid their premiums. That fact seems to us to be inherent in the nature of this experiment in annuity contracts. Holders of traditional annuity policies in Germany lost all their protection in the inflation of the twenties, and in France nearly all their protection in the post-war inflation. We have already adverted to the situation in this country. Experience in England has been similar.

The statutes which we have quoted above show an unmistakable determination on the part of Congress to leave the insurance business in the control of the States until Congress should in plain terms exert its power over some or all aspects of it. The appellants say that, by definition, the business of the appellees is not insurance. We find no such definition. The

definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance. The VALIC contracts have many qualities of the traditional business of insurance. They depart from the tradition only in their attempt to solve a problem badly in need of solution. Unless we confine insurance, by definition, to what has actually been done in the past under the name of insurance, and invent a new and distinctive name for this new business which so greatly resembles insurance, we should not contradict the insurance commissioners. The new business will need the expert and watchful supervision of these experts in insurance. We think the statutes lodge the responsibility with them.

The judgment of the District Court is

Affirmed.

Judgment

United States Court of Appeals for the District of Columbia Circuit

---

No. 14,253 April Term, 1958.

SECURITIES AND EXCHANGE COMMISSION, APPELLANT,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, INC., and

EQUITY ANNUITY LIFE INSURANCE COMPANY, APPELLEES.

No. 14,254 April Term, 1958.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., APPELLANT,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, INC., and

EQUITY ANNUITY LIFE INSURANCE COMPANY, APPELLEES.

Appeals from the United States District Court for the District of Columbia

---

Before: Wilbur K. Miller and Danaher, Circuit Judges, and Madden, Judge, United States Court of Claims.

These cases came on to be heard on the record from the United States District Court for the District of Columbia, and were argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the judgment of the said District Court appealed from in these cases be, and it is hereby, affirmed.

It is further ordered by the Court that appellees herein recover from appellant National Association of Securities Dealers, Inc., one-half the cost of printing their briefs in these cases, and have execution therefor.

Dated: May 22, 1958.

Per Judge MADDEN.

APPENDIX B

STATUTES INVOLVED

Section 2 (1) of the Securities Act of 1933 (48 Stat. 74, as amended; 15 U. S. C. 77b (1)) provides:

> SEC. 2. When used in this title, unless the context otherwise requires—
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3 (a) (8) of the Securities Act of 1933 (48 Stat. 76; 15 U. S. C. 77c (a) (8) provides:

> SEC. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> * * * * *
>
> (8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

Section 5 of the Securities Act of 1933 (48 Stat. 77, as amended; 15 U. S. C., Supp. II, 77e) provides:

> SEC. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.
>
> (b) It shall be unlawful for any person, directly or indirectly—
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or
>
> (2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.
>
> (c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the

effective date of the registration statement) any public proceeding or examination under section 8.

Section 3 (a) (1) and 3 (a) (3) of the Investment Company Act of 1940 (54 Stat. 797; 15 U. S. C. 80a–3 (a) (1) and (3) provide:

SEC. 3. (a) When used in this title, "investment company" means any issuer which—

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

* * * * *

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Section 3 (c) (3) of the Investment Company Act (54 Stat. 798; 15 U. S. C. 80a–3 (c) (3)) provides:

(c) Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:

* * * * *

(3) Any bank or insurance company; * * *

An insurance company is defined in Section 2 (a) (17) of the Investment Company Act (54 Stat. 790, 793; 15 U. S. C. 80a–2 (a) (17) as—

(a) When used in this title, unless the context otherwise requires—

* * * * *

(17) "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the

reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

Section 7 (a) of the Investment Company Act of 1940 (54 Stat. 802; 15 U. S. C. Sec. 80a–7 (a)) provides:

SEC. 7. (a) No investment company organized or otherwise created under the laws of the United States or of a State and having a board of directors, unless registered under section 8, shall directly or indirectly—

(1) offer for sale, sell, or deliver after sale, by the use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person; or offer for sale, sell, or deliver after sale any such security or interest, having reason to believe that such security or interest will be made the subject of a public offering by use of the mails or any means or instrumentality of interstate commerce;

(2) purchase, redeem, retire, or otherwise acquire or attempt to acquire, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person;

(3) control any investment company which does any of the acts enumerated in paragraphs (1) and (2);

(4) engage in any business in interstate commerce; or

(5) control any company which is engaged in any business in interstate commerce.

Section 24 (d) of the Investment Company Act (54 Stat. 826; 15 U. S. C. 80a–24 (d)) provides:

> The exemption provided by paragraph (8) of section 3 (a) of the Securities Act of 1933 shall not apply to any security of which an investment company is the issuer. The exemption provided by paragraph (11) of said section 3 (a) shall not apply to any security of which a registered investment company is the issuer, except a security sold or disposed of by the issuer or bona fide offered to the public prior to the effective date of this title, and with respect to a security so sold, disposed of, or offered, shall not apply to any new offering thereof on or after the effective date of this title.

Sections 27 (a) (1) and 27 (a) (2) of the Investment Company Act of 1940 (54 Stat. 797; 15 U. S. C. 80a–27 (a) (1) and 15 U. S. C. 80a–27 (a) (2)) provide:

> SEC. 27. (a) It shall be unlawful for any registered investment company issuing periodic payment plan certificates, or for any depositor of or underwriter for such company, to sell any such certificate if—
>
> (1) the sales load on such certificate exceeds 9 per centum of the total payments to be made thereon;
>
> (2) more than one-half of any of the first twelve monthly payments thereon, or their equivalent, is deducted for sales load;

The McCarran-Ferguson Insurance Regulation Act (59 Stat. 33, as amended; 15 U. S. C. 1011–1015) provides in pertinent part:

> *Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,* That the Congress hereby declares that the continued regulation and taxation by the several States of the business of

insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

SEC. 2. (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

* * * * *

SEC. 5. As used in this Act, the term "State" includes the several States, Alaska, Hawaii, Puerto Rico, Guam, and the District of Columbia.

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In the Supreme Court of the United States

OCTOBER TERM, 1958

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE PETITIONER

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OCTOBER TERM, 1958

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SECURITIES AND EXCHANGE COMMISSION, PETITIONER

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VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 257 F. 2d 201 (R. 885–891). The opinion of the District Court (R. 82) is reported at 155 F. Supp. 521.

JURISDICTION

The judgment of the Court of Appeals was entered on May 22, 1958 (R. 892). The jurisdiction of this Court rests upon 28 U. S. C. 1254 (1) which is made applicable by Section 22 (a) of the Securities Act of 1933 (15 U. S. C. 77v (a)) and Section 44 of the Investment Company Act of 1940 (15 U. S. C. 80a–43). The petition for a writ of certiorari was granted Oc-

tober 13, 1958, and the case was consolidated with No. 237.

QUESTIONS PRESENTED

1. Whether a company which sells to the public its "deferred variable annuity policies," contracts under which the purchaser receives a pro rata interest in the company's portfolio of securities and in the gains and losses therefrom, is required (a) to register those contracts pursuant to the Securities Act of 1933 and (b) to register as an investment company pursuant to the Investment Company Act of 1940, or whether exemptions in these Acts relating to annuities and to companies engaged in the business of writing insurance are available to the company.

2. Assuming such a company would otherwise be required to file a registration statement for its contracts under the Securities Act of 1933 and to register as an investment company under the Investment Company Act of 1940, whether an exemption from those Acts is provided by the McCarran-Ferguson Act of 1945.

STATUTES INVOLVED

The relevant statutory provisions of the Securities Act of 1933 (15 U. S. C. 77a), the Investment Company Act of 1940 (15 U. S. C. 80a–1), and the McCarran-Ferguson Insurance Regulation Act (15 U. S. C. 1011) are set forth in Appendix A, *infra*, pp. 63–69.

STATEMENT

This action was instituted in 1956 by the Securities and Exchange Commission to enjoin the Variable Annuity Life Insurance Company of America ("VALIC")

from (a) offering and selling securities in violation of the registration requirements of Section 5 of the Securities Act of 1933 (15 U. S. C. 77e), and from (b) engaging in enumerated activities prohibited by Section 7 of the Investment Company Act of 1940 (15 U. S. C. 80a–7) until registered as an investment company under Section 8 of that Act (15 U. S. C. 80a–8). R. 3–10. The Equity Annuity Life Insurance Company ("EALIC") and the National Association of Securities Dealers, Inc. were granted leave to intervene as party-defendant and party-plaintiff, respectively. R. 23, 28–29.

The respondents have been offering and selling what they describe as "variable annuities."[1] VALIC Br. in Opp. p. 2. The Securities and Exchange Commission contends that these contracts are securities subject to the registration provisions of the Securities Act of 1933 and that respondents, although they are chartered as insurance companies by the District of Columbia Department of Insurance, are investment companies subject to regulation under the Investment Company Act. It was on this premise that the Commission instituted injunction proceedings.

Of the several types of contracts offered by the respondents, the one which has been used by the lower courts as illustrative of the pertinent characteristics of these contracts is the "Deferred Variable Annu-

[1] In the litigation in the courts below, there has sometimes been confusion by reason of the parties' utilizing insurance or investment terminology. Since either tends to assume what is sought to be proved we shall try to confine our terminology to that of contract law.

ity." R. 567–578. While other contracts specifically adapted to certain types of persons or groups, are also sold (R. 101), the material respecting the deferred variable annuity contracts which describes the investment of the purchaser's capital in the respondents' securities portfolios and the use of units to represent this investment is common to all contracts. Findings of Fact 72 and 73, R. 109.[2] Under the terms of the Deferred Variable Annuity, the purchaser promises to pay to the company a fixed sum of money, usually at specified periodic intervals. R. 567. These payments continue until a "maturity date" which has been selected by the purchaser and which, within certain age limitations, may be changed by him at any time. R. 570. During the first year, 52 percent of the payment, and during later years, a lesser percentage of the payment is deducted for sales expense, R. 615–627,[3]

[2] The District Court stated in its opinion (R. 84): "Plaintiff's Exhibit No. 1, entitled 'Deferred Variable Annuity Policy', was received in evidence as a specimen of all the contracts that employ such investment practice (Appendix 1). It was issued and sold by VALIC. For purposes of clarity and convenience, it and VALIC will be referred to with the understanding that what is said applies to all similar contracts and companies issuing them." [A footnote inserted at this place in the District Court opinion reads: "EALIC stipulated that its contracts were in all material respects the same as those issued by VALIC."]

[3] The loading charges for subsequent years are: 12% of the amount invested for the 2nd through the 5th year; 11% of the amount invested for the 6th through the 10th year; and 8% for the 11th year and thereafter. These deductions, as well as the 52% referred to in the text above, are calculated by subtracting from 100% the percentage applied to purchase accumulation units. R. 615–627. However, the percentages are calculated not on the total payments made but upon what the company desig-

and the remainder[4] is pooled with monies received from other purchasers and is invested in a portfolio of securities. Finding of Fact 45, R. 107.

This portfolio is administered by respondents and common stocks are to be bought and sold in accordance with the investment judgment of their managements based upon recommendations of investment advisers which they retain.[5] As payments are made, securities are acquired for the portfolio. In return for the money invested, the purchaser is credited with a certain number of "accumulation units." R. 568–573. These units represent the purchaser's "aliquot" or undivided interest in the portfolio of securities purchased with his money (see Findings of Fact 43–47, R. 107), and therefore his interest fluctuates in direct relation to the value of the securities portfolio. Respondents use a complicated formula to determine the value of these units. (See Appendix B, *infra*, p. 70.) During the period in which the purchaser makes payments the contract provides that he may at any time make prepayments, thus acquiring units at a more rapid rate than is provided in the contract. Finding

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nates as the "basic annuity premium". In addition, the contract provides for still another deduction of 1.8% per annum on investments. R. 138, 573, 633.

[4] Deductions are made in certain instances for various optional features. See pp. 7–8, *infra*.

[5] Sales literature of EALIC, for example, states "You avoid buying stocks on a 'hot tip.' Instead, you benefit from the counsel of expert financial advisers; the Company purchases stocks upon the recommendation of The First National City Bank of New York. In short, you get the benefit of expert diversification." (R. 899.)

of Fact 48, R. 108, 520–521, 567, 568. Or he may liquidate and withdraw all or a portion of his units.[6] R. 572–573. In that event he receives a sum equal to the then value of the proportionate share of the fund's assets represented by the units redeemed. Findings of Fact 47, 50, R. 107, 108, 170. If he withdraws all of his units during the first five years of the contract, the company charges a penalty. R. 572.

After the maturity date, a date which has been preselected by the investor, presumably as the date on which he intends to retire, the purchaser is entitled to receive a series of monthly payments of fluctuating sums representing the then value of a fixed number of annuity units. R. 568–570. These units, like the accumulation units, represent an "aliquot" share of the portfolio of the securities of the fund. Finding of Fact 70, R. 109. The number of "annuity units" upon which the monthly payment is based is derived from the dollar value of the "accumulation units" at the

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[6] By prepurchasing or by partially withdrawing units the purchaser speculates upon the short term fortunes of the company's portfolio. If he purchases units in advance, he profits if they increase in value before the time when he would have normally purchased them under the contract. If he withdraws part of his units, he profits if the units decrease in value at the time he repurchases them just as a speculator who is "short" in the market. The purchaser may do this by making a policy loan which results in a partial withdrawal of sufficient of his units to give him the cash required. In this transaction, he "borrows" from the company the value of a number of units and the number of units credited to him is reduced by that number. When he repays the "loan," units are replaced at their then current value. Thus he may replace more or less units than he borrowed when he repays the money, depending on the interim fluctuations in the value of the portfolio. R. 572–573.

maturity date, *i. e.*, the dollar value of the first monthly payment is calculated by reference to an annuity table and this is translated into the number of "annuity units." R. 568, 573.[7] These payments continue for the rest of the purchaser's life, and during this period, under contracts presently being sold, he may no longer exercise the withdrawal privilege. R. 572. A prior contract issued by VALIC, however, pursuant to which respondents are still receiving payment, provided an option for payments over a fixed number of years with no mortality feature whatsoever (R. 897). VALIC ceased to sell this contract after the instant action was begun (R. 196).

As a part of the foregoing contract the respondents offer to insurable persons a five-year decreasing term insurance policy and a provision for the waiver of payment in the event of disability of the purchaser. R. 102–103. The cost of this insurance is paid out of the purchaser's fixed payment and results in a de-

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[7] By reference to a life annuity table on a 3½% interest basis there is determined the monthly fixed dollar annuity to which the purchaser would then be entitled if he had made a single payment equal to the then value of his accumulation units. This monthly fixed dollar amount is divided by the then current value of an annuity unit and the quotient constitutes the number of annuity units whose value will be paid monthly thereafter. The 3½% interest factor used in the annuity table is neutralized in the calculation of the value of the annuity unit by a reduction factor of .9971 (the reciprocal of 1.035 per year on a monthly basis). See Appendix B. As respondents' actuarial expert Towne testified: "The .9971 is the discounted value of a dollar at the end of a month back to the beginning on the assumption of earning the monthly equivalent of three and a half percent per year." R. 532.

crease in the amount actually invested in the respondents' portfolios.[8]

Under all the contracts sold by respondents the value of the purchaser's interest fluctuates at all times in direct relationship to the changes in the market value of the portfolio securities and other assets of the fund. Findings of Fact 44–49, R. 107–108. At no time under any of the contracts issued by the respondents is any portion of the purchaser's risk of investment loss borne by the respondents (Finding of Fact 49, R. 108). Respondents assume only the risk that the purchaser will survive his estimated mortality, in which event he is entitled to be supplied with the value of additional annuity units.

Both respondents in their sales campaigns appeal to prospective purchasers who have small sums available for periodic savings (Pl. Ex. 17 and 21). VALIC advertises that it will accept a "Monthly Investment" of $25 (Pl. Ex. 21, p. 21). Great emphasis is placed upon diversification and investment in "Basic American Industries" (Pl. Ex. 21, p. 5). The VALIC literature shows in bright colors and large type the names and trade-marks of dozens of the largest and best-known companies in America, despite the fact that its portfolio contains securities of only a

[8] A male aged 35 buying a 30-year variable annuity plan and paying $1,000 annual premium would have deducted out of his total payments $101 for the decreasing term insurance policy, $1,188 for the waiver of premium provision and $3,025 for sales load, leaving a net amount for investment of $25,686 out of his total payment of $30,000. R. 619.

few of these companies.[9] Having stated that the type of diversification which is desirable is possible only through the pooling of capital, the literature goes on to depict the dangers of idle capital. Charts are displayed which show over a 110 year period the decrease in the purchasing power of the dollar. (Pl. Ex. 21, p. 9.) And a chart purportedly shows how common stock prices have kept pace with this cost of living increase over a 60-year period. Although its avowed primary appeal is to the hope of secure retirement, VALIC also indicates that funds are available for (Pl. Ex. 21, p. 20):

> "Education of children
> "Your dream
> "Business opportunities
> "Travel."

Typical of the over-all appeal to the small investor to purchase these contracts is the question asked in large red and black letters in the VALIC literature: "If today you had available $36,516.00 to provide a Life Annuity because on a plan you had systematically set aside for yourself $50 a month or $600 per year for 20 years, would you be pleased?" (Pl. Ex. 21, p. 1; R. 769.)

The foregoing facts were elicited in a two-week trial. The District Court concluded that "the logic of the law applied to the established facts seems to bring

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[9] See Pl. Ex. 21 pp. 6 and 7. A disclaimer in much smaller type states: "The industries and securities shown here are for illustrative purposes only and may or may not be included in the Company's portfolio of investments at any given time." The portfolio, set forth at R. 849–850, contains only 13 percent of the companies listed.

the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants within the terms and plan of the Investment Company Act." It denied the injunction, however, on the ground that federal regulation is precluded by the McCarran-Ferguson Act (R. 89). The opinion stated that that Act was applicable because the respondents had been "chartered as insurance companies by the District of Columbia and their questioned contracts have been approved by the Insurance Superintendent of the District, and by the insurance departments of certain states" (R. 90). The opinion also stated that if the respondents had not been

> chartered, licensed and regulated by District and State authorities, and if Congress had not passed the McCarran Act, the questions raised by SEC would be answered by applying the rules of statutory construction to the Securities Act of 1933 and the Investment Company Act of 1940, and, in the opinion of this Court, such construction would bring the defendants within the purview and purpose of those statutes. [R. 90.]

The Court of Appeals affirmed the decision of the District Court, holding in addition that the contracts are within the exemptions provided by the securities laws for insurance. It stated that "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance." R. 891.

SUMMARY OF ARGUMENT

1. Purchasers of respondents' variable annuities receive an interest the value of which is determined by the fluctuating value of a fund which purportedly consists primarily of common stocks. For this reason they need the information provided by the registration provisions of the Securities Act of 1933 and should get the benefit of the protection provided by the regulatory provisions of the Investment Company Act of 1940. Indeed, the respondents' variable annuities, except for the mortality feature which determines the duration of payments by the companies, do not differ materially from securities issued by companies which the Investment Company Act was expressly designed to regulate—periodic payment investment plans.

The legislative history of the Investment Company Act shows that, like the variable annuities, periodic payment plans had great attraction for investors having small sums of money available for periodic savings. The sales literature for these plans was of the same tenor as that used by respondents and included features, also used by respondents, which were considered objectionable. Among these were projection charts purporting to predict the future experience of a securities portfolio on the basis of general stock market averages of prior years. It was also noted in the legislative history that from the sums paid in by investors in these periodic payment plans, large, and often not fully disclosed, fees were deducted; this is also the case with respect to respondents' variable annuities.

Even though the securities sold by investment companies, including periodic payment plans, had been subject to the full disclosure requirements of the Securities Act of 1933, Congress found it necessary to enact the further protections of the Investment Company Act of 1940 giving regulatory power over such companies to the Securities and Exchange Commission.

There can be no question that the respondents fail to meet protective requirements of both the Securities Act and the Investment Company Act.

2. Since variable annuities are the kind of contract which the Securities Act was designed to cover and since the abuses attendant upon their sale are the kind of abuses intended to be remedied, they should be considered non-exempt securities within the meaning of the Act if it can fairly be construed to encompass them. The variable annuity falls squarely within the statutory definition of securities; it is a "certificate of interest or participation in any profit-sharing agreement," since its avowed purpose of keeping pace with a possible rise in the cost of living may be achieved solely through profits; it is also an "investment contract," which this Court has construed as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party * * *."

Variable annuities do not fall within the exemption for insurance or annuities. Purchasers of insurance policies or of traditional annuities are interested in

being compensated in a fixed amount upon the occurrence of a specified event; accordingly, they need not be primarily concerned with the investment policies of the company writing the insurance, if, as the Congress assumed, state supervision provided sufficient protection as to solvency and the adequacy of reserves. The purchaser of a variable annuity, on the other hand, is vitally interested in the investment risk, which will increase or decrease the amount of his return. When the statute was enacted, the term "annuity" did not include a variable annuity; the definition of an annuity then current related to a periodic "payment of a certain sum of money," which "does not vary by reason of profit or income."

The purchaser's need for information to assess his investment risk is not altered by the insurance features of respondents' variable annuities. Term insurance and a premium waiver provision, which are often sold with the contract, are in addition to its central features and were found by both courts below to be irrelevant to the issues. The mortality feature, determining the duration of the payments by the companies, seeks to solve the problem that the purchaser might otherwise outlive his savings, but this problem cannot be satisfactorily solved if his savings may be lost, or seriously diminished, through unsuccessful common stock investment. During the pay-in period of the contract there is, of course, no mortality feature whatsoever.

Whatever weight this Court feels should be given to the fact that insurance commissioners in some states

and in the District of Columbia have determined that these contracts are insurance, this fact by itself cannot be determinative of the construction to be given a federal statute and should not be given precedence over the contrary interpretation of the Securities and Exchange Commission which is the agency selected by Congress to administer the Act. Moreover, state insurance commissioners are sharply divided on whether these contracts are insurance and the only state case ruling upon a comparable contract held that it was not an annuity as that term was used and understood. *Spellacy* v. *The American Life Insurance Association,* 144 Conn. 346.

3. The respondents fall squarely within the definition of investment companies contained in Section 3 of the Investment Company Act and they are outside the exception thereto relating to insurance companies. That exception is available to a company primarily and predominantly engaged in the writing of insurance. In the light of the dominant legislative purpose of this statute, variable annuities cannot be considered insurance for the same reasons they do not fall within the exemption for insurance and annuities in the Securities Act. Moreover the basic economic factors relating to respondents' business differ substantially from those relating to insurance companies.

4. The respondents contend, and both courts below held, that the McCarran-Ferguson Act of 1945 precludes regulation of the respondents by the Securities and Exchange Commission. That Act was passed to counteract this Court's decision in *United States* v.

South-Eastern Underwriters Association, 322 U. S. 533, which determined that insurance was commerce and was subject to the antitrust laws. It was not the purpose of the McCarran-Ferguson Act to clothe the States with powers over or above those which they had prior to the Supreme Court decision. *Maryland Casualty Co.* v. *Cushing,* 347 U. S. 409.

The first answer to the respondents' claim is that basing it on the McCarran-Ferguson Act adds nothing to the argument that exemptions for insurance in the securities acts are applicable. Unless "insurance business", the term used in the later statute, covers something more than those exemptions, the arguments as to why those exemptions are not applicable is equally pertinent here. There is no basis for giving the language in the McCarran-Ferguson Act a wider interpretation.

Moreover, even on the assumption that the term "insurance business" was intended to cover more than the previous exemption, still there is no basis for finding that the Securities and Exchange Commission's authority over these contracts or the respondents was intended to be affected. As the legislative history makes clear, the McCarran-Ferguson Act was intended to reestablish the power of the States to tax and to regulate insurance, regardless of its being interstate commerce, and to suspend the application of the antitrust laws to insurance. There was no intent otherwise to affect concurrent federal power to regulate insurance.

Finally, the McCarran-Ferguson Act, by its express language, was not intended to limit the application

of any act which "specifically relates to the business of insurance" (15 U. S. C. 1012) but only to prevent a misconstruction of "silence on the part of the Congress." 15 U. S. C. 1011. In the securities acts Congress spelled out the application of their provisions to insurance and, for this reason also, the McCarran-Ferguson Act provides no exemption.

ARGUMENT

I

THE VARIABLE ANNUITY CONTRACTS OFFERED BY THE RESPONDENTS ARE NON-EXEMPT SECURITIES UNDER THE SECURITIES ACT OF 1933 ISSUED BY NON-EXEMPT INVESTMENT COMPANIES UNDER THE INVESTMENT COMPANY ACT OF 1940

A. THE FEDERAL SECURITIES ACTS WERE DESIGNED TO PROVIDE PROTECTION FOR INVESTORS PURCHASING SECURITIES SIMILAR TO THE VARIABLE ANNUITY CONTRACTS SOLD BY THE RESPONDENTS

Every purchaser of the respondents' contracts receives an interest the value of which is determined by the value of a fund, managed by respondents, which respondents represent will consist primarily of common stocks. This is the very type of situation at which both the Securities Act of 1933 and the Investment Company Act of 1940 were directed. That the contracts now being sold by respondents also include a mortality feature solely during the "pay-out period" [10] does not except them from the aim of these statutes nor decrease the need for federal regulation.

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[10] For purposes of convenience we shall refer to the period before maturity when the purchaser is making payments as the "pay-in period" and the period after maturity when he is receiving payments as the "pay-out period."

The Securities Act of 1933 provides essentially that, when an offer is made of an interest in an enterprise managed by someone other than the person who furnishes the capital, there must be full disclosure, portraying the risks as well as the possibility of profits. Persons desiring to sell securities in interstate commerce or through the mails must register them with the Securities and Exchange Commission and transmit to every purchaser a prospectus meeting the requirements of Section 10 of the Securities Act (15 U. S. C. 77e, 77j). This Section and the regulations promulgated thereunder set forth the business, financial and other information which is considered necessary for the intelligent consideration of the purchase of a security. For example, there must be complete financial statements certified by independent accountants, detailed information as to the type of venture, the risks involved, the underwriting expenses, the amount of capital needed, the interests of management and various promoters in certain financial transactions and numerous additional matters. The Commission is given various powers under the Act, including the power to make necessary rules and regulations and to enjoin violations and otherwise to enforce the Act (see *e. g.* Sections 19 and 20; 15 U. S. C. 77s, 77t).

As we have noted, the purchaser of respondents' variable annuity contracts furnishes funds which are used by the company to purchase traditional investments, primarily common stocks. The risk of loss from these investments is borne by the purchaser, who also receives the profits, after deduction of various

fees and charges. The purchaser does not participate in the management of the portfolio, but must rely on the ability of the management of the respondents and the persons whom they employ as investment advisers. The only thing that a purchaser of a variable annuity knows with any degree of certainty is what his own payments to the company will be. Even if he should see the contract—and the evidence is that the purchasers did not see the contract until they had incurred the obligation (R. 361)—he could not learn sufficient facts to enable him to exercise an informed judgment concerning the merits of the investment. The purchaser does not know the investment policy of the management, *i. e.*, what types of stock it will purchase or indeed the extent to which it might also purchase bonds, debentures, or real estate, or simply keep funds in the bank.[11] He does not know the present portfolio or the size of the company in which he is investing. The failure of sellers of securities to disclose the same type of information led to the enactment of the Securities Act.[12]

Even the full disclosure required by the Securities Act of 1933, however, was not considered adequate

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[11] Despite the emphasis in VALIC's sales literature that its portfolio was to consist of common stocks, the record shows that one and a half years after VALIC's incorporation, at the time of the District Court trial, VALIC's securities were substantially all in bonds and debentures (R. 849–50).

[12] The legislation was initiated by a message from President Franklin D. Roosevelt, dated March 29, 1933, reprinted at pp. 6–7 of S. Rep. No. 47, 73d Cong., 1st Sess., in which he stated:

"There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no

regulation for companies which were "essentially institutions which provide a medium for public investment in common stocks and other securities"—as investment companies are referred to in the Senate Report on the Investment Company Act of 1940 (Senate Report No. 1775, 76th Cong., 3d Sess. (1940), p. 2). That report points out: "Investors have suffered tremendous losses on their investment in such companies." (*Id.* at p. 3.) Largely as a result of detailed studies made by this Commission it states that there were "various problems with respect to the organization and operation of investment companies which should be remedied by legislation." (*Id.* at p. 6.)

The Senate Report discusses at some length the situation where interests were purchased in these companies on installments. It distinguishes these periodic payment plans from "programs sponsored by savings banks, building and loan associations, insurance companies, etc.," noting that the "holder of a periodic payment plan certificate is not entitled to be repaid a

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essentially important element attending the issue shall be concealed from the buying public."

The House Committee on Interstate and Foreign Commerce reported as follows (H. Rep. No. 85, 73d Cong. 1st Sess., p. 7): "No honestly conceived and intelligently worked out offering, floated at a fair but not exorbitant profit, will be injured by the revelation of the whole truth which these requirements seek to elicit. The requirement of comparable information, at the time of the offering, of many of the most fraudulent issues, in which the public has suffered the greatest losses in late years, would have prevented their flotation. A compulsory revelation of the whole truth will give impetus to honest dealing in securities and help to bring back public confidence."

fixed sum of money or a fixed amount of income, but is entitled to receive only the asset value of his certificate." (*Id.* at p. 8.) The Senate Report continues (*id.* at pp. 8–9):

> This asset value is in essence based upon the market value of the securities in the portfolio of the investment company or investment trust underlying the installment investment certificate. The amount to which the certificate holder is entitled may be less than, equal to, or more than the amount paid by the certificate holder, depending upon market prices of these portfolio securities which almost invariably consisted of common stocks. The purchaser of a periodic payment plan certificate is, therefore, speculating or investing in the stock market.

With respect to these periodic payment plans, the Senate Report also points out (*id.* at p. 9) that they:

> were specifically designed to make their strongest appeal to wage-earning men and women who were not in a financial position to invest or speculate in common stocks. As a result, these certificates were sold to housewives, domestic workers, laborers, nurses, stenographers, clerks, and others who had little financial experience. Inasmuch as the refinement and technique of the operation of periodic payment plans are intricate, they were far beyond the comprehension of the class of persons to whom these certificates were sold.

In noting that the studies had shown that these plans were the subject of flagrant misrepresentation by unscrupulous salesmen, the Senate Report specifically

referred to representations respecting "supposed similarities between the plans and savings accounts and insurance and endowment policies," concluding (*id.* at p. 10):

> Emphasis on the "savings" in the periodic payment plan literature was made in an effort to meet the sales resistance of a prospective purchaser to a speculative incursion into the investment field.

The periodic payment plans referred to in the Senate Report are identical in many respects to the variable annuity plan. Both base their sales literature upon similar appeals to the small investor seeking financial security through planned and systematic savings and both are sold for the most part in installments. The above-quoted language of the Senate Report to the effect that a purchaser of a periodic payment plan certificate is "not entitled to be repaid a fixed sum of money or a fixed amount of income," but receives a payment "based upon the market value of the securities in the portfolio," is equally applicable to the purchaser of a variable annuity. Thus the latter is also, in the words of the Senate Report, "speculating or investing in the stock market." [13]

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[13] The respondent VALIC has suggested that variable annuity contracts are not suitable for speculation because the purchaser's profits may be taxable as regular income rather than as capital gains. Br. in Opp., p. 16, fn. 10. However, speculation as used here does not mean trading in and out of the contracts, although even in that sense the contracts do contain provisions which permit a holder to guess on relatively short swings. See pp. 5–6, *supra*. Here, speculation is used in the sense that the purchaser anticipates gains or losses by reason of price fluctuations of particular stocks.

An examination of a report of this Commission relating to "Companies Sponsoring Installment Investment Plans" (H. Doc. No. 482, 76th Cong. (1940)),[14] which is referred to in the Senate Report (p. 4), illustrates numerous detailed points of similarity between the periodic payment plan and the variable annuity plan. The Installment Plan Report states (p. 3) that "[i]n order to increase the sales allurement of the plan and to strengthen the claim of 'protection' held out by the promoters, an optional provision for life insurance was generally offered, * * *." The same purpose may be attributed to the term insurance feature which is often a part of the variable annuity plan.

As to fees, the report states that in periodic payment plan offerings a "fixed percentage" of the amount paid by the certificate holder was "generally deducted in the first year of the operation of the plan from the payments made by the certificate holder" (*id.* at p. 25). It noted that since the greater part of the service fee was obtained the first year, "only a small portion of the certificate holder's payments was actually invested for him in the underlying securities until the second or third year," resulting in a "loss of dividend-earning potentialities during the first years of the plan" and losses to the investor who withdrew in the first years of the plan (*id.* at p. 34). The report notes also that in some cases "the certificate holder's funds after investment were subject to management fees or supervisory fees"

[14] This will be referred to herein as "Installment Plan Report."

(*id.* at p. 38). In addition, the report points out (*id.* at p. 26) that "[u]pon withdrawal or redemption of the installment investment plan certificate by the holder prior to maturity, the net proceeds of the certificate holder's account was occasionally subject to withdrawal or termination fees."

As previously noted, *supra,* p. 4, the respondents here make an initial charge of 52 percent of the first year's investment; the contract provides for an additional annual charge of 1.8 percent of the investments, comparable to the management fees discussed in the report (which were stated to bear "no relationship to any actual management of the * * * fund" (*id.* at p. 38)); [15] and for a termination fee during the first five years of the contract. The same problems arising from the fees charged in connection with periodic payment plans necessarily obtain with respect to respondents' fees.

Examination of the Installment Plan Report discloses numerous other parallels between the periodic payment plans and the respondents' plans. The report notes for example that all contracts were not sold by installments but that "to attract the funds of those who could afford to make a fairly substantial lump sum investment, a 'fully paid certificate' was also sold" (*id.* at p. 3). Respondents, in addition to their usual installment contract, also sell a deferred single-payment contract (R. 677). The periodic payment plans contained a provision "in many instances * * *

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[15] This fee is hidden in the rather complicated formula for the computation of the value of the accumulation unit and annuity unit. See Appendix B, *infra,* p. 70.

for partial withdrawal." (Installment Plan Report, p. 30) Respondents advertise an almost identical provision (R. 775). Under some periodic payment plans, the report states (p. 32), provision was made for loans to a certificate holder "with his net investment as collateral." A similar provision is contained in respondents' contracts (R. 572). The report notes also (p. 31) with respect to periodic payment plans, as is true in the case of respondents' plans, that the "completion of payments * * * was generally termed the maturity" of the plan.

In the realm of sales promotion the similarities between the respondents' plans and the periodic payment plan are striking. The Installment Plan Report states (p. 6) that, by reason of the "construction and nomenclature of the installment plan" and the kind of publicity used, there was given an impression "that these plans were similar to savings bank thrift plans or insurance endowment plans." The selling literature used in connection with the sale of periodic payment plans was of a similar tenor to that used by respondents. See pp. 8–9, *supra*. The report points (p. 165) to the "emphasis placed upon the 'great corporations,' the common stocks of which underlay the installment plan," noting that there was a "tendency to confuse the soundness of the 'great corporations' with the soundness of the installment plan, by many certificate holders." The report also contains various typical selections of sales literature used for periodic payment plans, including the following:

> An Insured Investors Income-Building Plan makes it possible for YOU to participate in the

earnings of 32 leading industrial corporations of America, corporations upon whose functioning depends the very structure of our economic system. [Installment Plan Report, p. 165.]

Commonwealth Fund Provides Living Assurance by Enabling You Now to—

Create a Living Trust for the education of your children.

To buy your own home or establish a business.

To provide a sinking fund or business reserve.

To meet an emergency or an opportunity.

For travel and comfort in your later years.

LIVING ASSURANCE means peace of mind—security and freedom from financial worry. [*Id.* at p. 167.]

What could be nicer than a Comfortable Old Age, with an assured monthly income from your own estate? Regular dividend checks. Freedom from financial worries. Let the profits of American Industry help you build your estate. [*Id.* at p. 168.]

One of the most troublesome features in connection with the selling literature of the periodic payment plans was the use of "projections," and charts of previous market prices. The report states (p. 171):

Imposing charts and statistical material formed a considerable part of the sales approach of the installment plan distributor. Naturally, the statistics and analyses presented to the public were favorable to the plan. Periods of time were chosen when they particularly favored the interpretation desired by

> the sponsor. Past performances of securities in the market were projected into the future to "prove" the selling argument of the sponsor. "Projections," upon which "reasonable predictions" were made, even selected general security prices as far back as 1900 and 1910 to show the probability of the appreciation of the underlying stocks in the future.

This language could have been written about the sales kit used by VALIC which displays the trade marks of corporations whose stocks are not contained in its portfolio and uses charts predicated on the performance of hundreds of stocks for periods of time during most of which VALIC was not in existence. Pl. Ex. 21, pp. 6–7, 22–25. Indeed one of its market charts goes back to 1897. Pl. Ex. 21, p. 10. Plaintiff's selling literature contains a disclaimer of "assurance to the policy-holder" as to the continuance of past trends (*ibid.*) but the Installment Plan Report noted (p. 172) that even where such assurances were given "the possibilities for abuse in the use of such projections remained. Salesmen could still take advantage of a credulous prospect. The figures were misleading and did not give a complete picture of the hazards involved."

Finally, in connection with the sales methods used, the report noted the admitted "difficulty in enlightening the prospective purchaser of the installment investment certificates" on the subject involved. It stated (p. 22).

> Security dealers and salesmen themselves encountered difficulty in understanding the plans.

In order to make clear the terms and implications of the plan, detailed and careful disclosure was required, particularly because of the type of investor to which the plan appealed.

We submit that respondents' plans are, if anything, more complicated than the periodic payment plans of which the report speaks. (See Appendix B, p. 70, *infra.*)

The Investment Company Act of 1940 was enacted to deal with the problems pointed out in this and other reports of the Commission.[16] The Act states that it is based on the "facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935 [15 U. S. C. 79[illegible]-4], and facts otherwise disclosed and ascertained * * *." (See Section 1 (a) and Section 1 (b); 15 U. S. C. 80–1a (a) (b)). The latter Section declares "that the national public interest and the interest of investors are adversely affected—

"(1) when investors purchase * * * securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management; * * *."

[16] Section 1 (a) (5) (15 U. S. C. 80a–1 (a) (5)) declared that investment companies are affected with a national public interest because, among other reasons, the activities of such companies "extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors."

That section also sets forth the rule of construction to be followed in interpreting the provisions of the Act, by declaring "that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

The Investment Company Act generally requires registration of investment companies by making it unlawful for unregistered companies to make use of the mails or the instrumentalities of interstate commerce in the operation of their business (Section 7; 15 U. S. C. 80a–7). Registration with the Commission pursuant to Section 8 (15 U. S. C. 80a–8) subjects the company to the broad scope of regulation under the Act, which includes restrictions on the personnel, capital structure, and other activities of a registered investment company and its affiliated persons. See *e. g.* Sections 9, 10, 17 and 18; 15 U. S. C. 80a–9, 10, 17, 18. Section 8 requires that the management adopt a set of fundamental investment policies concerning, *inter alia,* the diversification of the investment company's assets; the borrowing of money; the concentration of investments in any one industry or group of industries; the purchase and sale of real estate; and portfolio turnover. Once adopted, Section 13 (15 U. S. C. 80a–13) makes it unlawful to deviate from these fundamental policies without a vote of its security holders. The Act also emphasizes the importance of the investment adviser. Section 15 (15 U. S. C.

80a–15) requires that he may only serve pursuant to written contract approved by the security holders which shall include the fees to be paid him and contain provisions for its termination at the will of the security holders or automatically in the event of its assignment.

Section 27 of the Act (15 U. S. C. 80a–27) is devoted entirely to "periodic payment plans." It provides, among other things, that it is unlawful for companies "issuing periodic payment plan certificates * * * to sell any such certificate, if—

> (1) the sales load on such certificate exceeds 9 per centum of the total payments to be made thereon;
>
> (2) more than one-half of any of the first twelve monthly payments thereon, or their equivalent, is deducted for sales load; * * *

The Commission has authority under the Act to make rules and regulations (see *e. g.* Section 38; 15 U. S. C. 80a–37) and to enjoin violations and otherwise to enforce the Act and rules thereunder (Sections 36 and 42; 15 U. S. C. 80a–35, 41).

Purchasers of respondents' variable annuities have no protection comparable to those afforded by the Investment Company Act. As indicated above, the respondents' charges are in excess of those permitted under Section 27 of the Act. Respondents' sales literature violates in many respects a Statement of Policy, adopted by this Commission in connection with its administration of the Securities Act of 1933 and the Investment Company Act of 1940, in which the Com-

mission enumerates certain practices with respect to sales literature of investment companies that the Commission believes are "false and misleading". The Statement of Policy was first adopted in 1950 after comprehensive studies of sales literature used in the sale of investment company shares and, after opportunity to all persons to comment on drafts of the proposed statements, it has been twice revised in the light of subsequent experience.[17] It sets forth standards with respect to representations as to such matters as the rates of return on the investor's capital, the safety of his capital,[18] the effect of government supervision on the management of the company, the benefits of dollar averaging and continuous investment, and the amount of the commissions charged. It limits the use of reprints from articles relating to the whole investment company industry. It restricts the use of charts using information based on market indices.[19] Respondents' utilization of Dow-Jones in-

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[17] Securities Act Release No. 3385 (1950), 15 Fed. Reg. 5468; Securities Act Release No. 3530 (1955), 20 Fed. Reg. 791; Securities Act Release No. 3856 (1957), 22 Fed. Reg. 8977.

[18] For example, the Statement of Policy states that it will be materially misleading:

"To discuss accumulation of capital, preservation of capital, accumulation of an estate, protection against loss of purchasing power, diversification of investments, financial independence or profit possibilities without pointing out or explaining the market risks inherently involved in the investment." 15 Fed. Reg. 5468.

Cf. VALIC's advertisement that its contracts are "INFLATION-PROOF ANNUITIES" (R. 761).

[19] The Statement of Policy spells out in detail specifications to which charts should conform. It states generally that it will be considered materially misleading:

"To use any chart or table which is inaccurate in factual detail or tends to create a false or misleading impression as to

dustrial average and Standard and Poor's 480 Stock Combined Index as an indication of the assumed performance of a variable annuity in the past (Pl. Ex. 21, pp. 8, 13) is a gross violation of the standards set forth in the Statement of Policy.[20] Indeed, under that Statement it is improper to use charts which contain statistics antedating the fund or company involved.

Approximately ten billion dollars of assets are held by numerous open-end investment companies, whose shares represent interests similar to the respondents' accumulation units and whose methods of valuation of these shares is basically the same as the method followed by respondents in valuing the units they sell (R. 725). Many of these companies sell periodic payment plans and, like respondents, receive their funds primarily through installments. Certain of these, such as United Funds, Inc., referred to in the findings of the district court, sell insurance in con-

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any material aspect of the investment company's past performance or of an assumed investment of any investor in the investment company, or appears to represent that the investment company's past performance or investor experience will be repeated in the future. * * *" 22 Fed. Reg. 8978.

[20] It is never explicitly stated that to have achieved a similar investment result respondents would have had to invest in these securities in equal proportions. Even assuming that respondents could or would wish to invest in all the shares upon which the Standard and Poor's Index is based and even making the wholly unwarranted assumption that those stocks would have the same yields and appreciation as in years past, the amount invested with respondents could not have a similar increase in value because of the large deductions enumerated above. (Page 4, *supra*.) As we have seen in footnote 11, *supra*, page 18, VALIC's portfolio is almost all invested in bonds and debentures.

nection with their plan and their salesmen "are required to be licensed as insurance salesmen by the Insurance Commissioners of some states and by the Superintendent of Insurance of the District of Columbia." (Finding of Fact 84, R. 110). Another investment company selling periodic payment plans will by arrangements with an insurance company, at the maturity of their contracts, convert the value thereof into an annuity based upon a mortality table guaranteed at the inception of the plan (R. 805–12). These companies are registered with this Commission under the Investment Company Act of 1940 and their contracts are registered pursuant to the Securities Act of 1933.

As we indicated in the petition for certiorari, the Commission has no desire to prevent economic experimentation whereby an individual might be able to provide adequately for his years of retirement in the face of a possible rise in the cost of living. Such experimentation, however, must be within the framework of the restrictions imposed by Congress upon persons seeking to obtain the funds of others for investment. The mere fact that the contract involved is claimed to be an "attempt to solve a problem badly in need of solution," as noted by the court below (R. 891), is not sufficient to remove it from otherwise applicable federal regulation. Indeed, the originators of the periodic payment plans also "claimed that these plans were created and developed in order to fill an economic need" (Installment Plan Report, p. 3).

The provisions of the Securities Act and of the Investment Company Act must be read in the light of

their background and the purposes, described above. Since the nature of the enterprises here involved and the possibilities of abuse inherent in the sales of their contracts fall squarely within the intent of Congress, the language of the two Acts should be read to cover the sales of these interests, if it can fairly be done. We shall show below that the Acts are properly construed to apply to the respondents and their contracts.

B. THE VARIABLE ANNUITY CONTRACTS ARE NON-EXEMPT SECURITIES UNDER THE SECURITIES ACT OF 1933

The respondents have argued in the courts below that the contract they offer for sale is not a "security," as that term is defined in the Securities Act of 1933 [21] and that in any event it falls within an exemption from registration applicable to "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner * * * or any agency or officer performing like functions, of any State * * * or the District of Columbia." [22] In determining these questions, as this Court has indicated, "The focus of inquiry should be on the need of the offerees for the protections afforded by registration." [23]

The purchaser of a security is interested in the amount of return on his investment and the possibility of profit, and he must weigh against these the risk of decline in income and of loss. His risk is identical

[21] Section 2 (1) (15 U. S. C. 77b (1); Appendix A, *infra*, p. 63.

[22] Section 3 (a) (8) (15 U. S. C. 77c (a) (8)); Appendix A, *infra*, p. 63.

[23] *Securities & Exchange Commission* v. *Ralston Purina Co.*, 346 U. S. 119, 127.

to that of all others who purchase the same security. Since the purchaser of a security can learn little of the merits of a proposed investment by means of the document evidencing participation therein,[24] the Securities Act requires full disclosure to enable him adequately to appraise his investment risk.

The purchaser of insurance or of a traditional annuity, on the other hand, is interested in being compensated in a fixed amount upon the occurrence of some hazard which is personal to him but to which many are susceptible, as for example early death or living beyond an anticipated life span. Since insurance companies were at the time of the passage of the Securities Act regulated by the individual states to give assurance that they should be solvent and able to carry out their obligations, and since the interests of persons buying insurance was in whether the insurance companies would be financially able to pay the agreed compensation, rather than in investment policies which would determine the day-to-day market values of the companies' investments, Congress provided an exemption for insurance (Section 3 (a) (8), Appendix A, *infra,* p. 63), just as it did for bank deposits and building and loan shares (Section 3 (a) (2) and (5) of the Securities Act, 15 U. S. C. 77c (a) (2) and (5)), apparently determining that it was not necessary to require sellers thereof to furnish all the information required by the Securities Act.

The purchaser of a variable annuity will be compensated not in a fixed amount, however, but on the

[24] It is noted in the House Report on the Securities Act "that securities are intricate merchandise." H. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 8.

basis of units of a portfolio of common stocks purchased by the company. Hence, there exists not only the personal hazard but also the investment risk common to all purchasers of securities. As respondents' expert testified, the variable annuity cannot insure against this investment risk (R. 460).[26] Accordingly, the purchaser of a variable annuity, like any other purchaser of securities, should be advised of all material information bearing on his investment.

Examination of the definition of a security in Section 2 (1) of the Securities Act (15 U. S. C. 77b, Appendix A, *infra*, p. 63) and of the exemptive provisions for insurance policies in Section 3 (a) (8) of that Act (15 U. S. C. 77c (a) (8), Appendix A, *infra*, p. 63), interpreted as they must be in the light of the dominant legislative purpose discussed above,[27] makes it clear that the variable annuities sold by respondents are not exempt securities. The term

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[26] Professor Mehr, a professor of economics specializing in insurance (R. 453), testified on behalf of respondents (R. 460):

"Now, if a person owns, if a group of people all own, a given investment, if that investment goes bad, all those owning such investment would lose and there would be no way in which that loss can be shared among those who are exposed to that loss, so that it is impossible to have two things—prediction of loss and sharing in the predicted loss; therefore, it is not insurable."

[27] See *Securities & Exchange Commission* v. *Joiner Corp.*, 320 U. S. 344, 350–351, where this Court, in construing the definition of a security, pointed out that "courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy."

"security" is broadly defined by Section 2 (1) of the Act. As Mr. Justice Jackson pointed out in *Securities & Exchange Commission* v. *Joiner Corp.* (320 U. S. 344, 351):

> * * * the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'"

The contracts sold by respondents are clearly "certificate[s] of interest or participation in any profit-sharing agreement" within the language of Section 2 (1) of the Securities Act (15 U. S. C. 77b). The purpose of providing a fund and retirement income which might be able to keep pace with a rising cost of living can be achieved only through profits. Indeed, this purpose has historically been a function of investment in equity securities. As we have seen, respondents' contracts are basically similar to periodic payment plans sold by investment companies, which also fall squarely within this definition. The fact that respondents borrow insurance terminology cannot affect the essential nature of the instrument. As indicated in *Securities & Exchange Commission* v. *Howey Co.*, 328 U. S. 293, 298, "form" must be "disregarded for substance" and emphasis must be "placed upon economic reality."

Variable annuities are also "investment contracts," another statutory term used in defining a security (15

U. S. C. 77b). In both the *Joiner* and the *Howey* cases it was held that the term "investment contract" encompassed an instrument which in form was an interest in real estate but which by reason of extrinsic facts became a contract primarily for the "placing of capital or laying out of money in a way intended to secure income or profit from its employment." (*Securities & Exchange Commission* v. *Howey Co.*, 328 U. S. at 298.) In the *Howey* case this Court defined "an investment contract for purposes of the Securities Act" as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, * * *." (328 U. S. at 298–299).[28]

The contracts issued by respondents come directly within this language. Under the terms of these contracts, payments, or "investments," as one of the purchasers referred to them (R. 362), were made to the

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[28] The decision of the Fifth Circuit in *Haberman* v. *Equitable Life Assurance Society*, 224 F. 2d 401, 225 F. 2d 837, certiorari denied, 350 U. S. 948, is not authority for the respondents' claim that their contracts are not securities. That case dealt with an ordinary annuity with no variable feature and held that it was insurance, not a security. The reasoning of the court would seem inapplicable to the novel type of contract here involved. Moreover, the case does not deal with the Securities Act at all, but with the Texas law. That statute borrowed from the federal Securities Act certain language in defining the term security, but it did not follow the federal law in providing an exemption for insurance. Since the court was convinced that the interests sold were clearly insurance and that there was no intent to impose securities regulation on insurance companies, it construed the definition as excluding the annuity contract involved.

respondents in return for an undertaking by the respondents to manage the funds and to apply any profits or losses which might result from that management to the interest held by the purchasers of the contracts. The purchasers are motivated in large part by the desire for profit arising from the appreciation in stock market values to enable them to keep pace with any rise in the cost of living. The District Court found (Finding of Fact 74, R. 109–110);

> A VALIC and an EALIC contract holder invests money with the respective defendants with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased by VALIC and EALIC with the money invested by the contract holder, and his expectation of profit based upon the efforts of others applies to both the "accumulation period" and to the repayment or variable annuity period.

The need of a purchaser of a variable annuity for information with which to assess his investment risk is important not only in determining whether the variable annuity is a security but also in determining whether it is exempt from registration.[29] As this

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[29] Section 3 (a) (8) of the Securities Act (15 U. S. C. 77c (a) (8)) provides:

"Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

* * * * *

"Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions,

Court pointed out in *Securities & Exchange Commission* v. *Ralston Purina Co.*, 346 U. S. 119, 125, in dealing with another exemptive provision of the Act:

> Since exempt transactions are those as to which "there is no practical need for [the bill's] application," [i. e. the Securities Act's application] the applicability of * * * [the exemption] should turn on whether the particular class of persons affected needs the protection of the Act.

There can be no question that the term "annuity contract" used in Section 3 (a) (8) was not specifically designed to encompass "variable annuities" since there were no variable annuities in 1933 when the Act was adopted. The differences between a variable annuity and an "annuity contract", as such contract existed in 1933, eliminate the reason for the exemption.

The term "annuity" was defined in the early 17th Century by Sir Edward Coke as "the yearly payment of a certain sum of money" [30] and that definition has continued to be standard. A leading authority on annuities, in a book published in 1933, the date when the Securities Act was passed, stated:

> Briefly defined, an annuity represents a series of certain payments, generally equal in amount, made at uniformly recurring intervals of time

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of any State or Territory of the United States or the District of Columbia;"

* * * * *

[30] This was quoted in Mehr and Osler, *Modern Life Insurance* (1949), p. 70.

> to a named person or persons during the continuance of a specified condition or status. * * * There is a difference, strictly speaking, between an annuity and a periodic income. While an annuity, as previously stated, represents a definite sum guaranteed to be paid, an income is made up of net profits after deducting all necessary expenses and charges, and, therefore, may be indefinite in amount. An annuity does not vary by reason of profit or income.[31]

There may have been minor variations in the definition of annuity but, as respondents' expert, MacLean, conceded, "any definition of an annuity which was promulgated, written, prior to the year 1952, naturally did not contemplate or include within its terms the possibility of a variable annuity" (R. 490).

Since the purchaser of a variable annuity needs the protection of the Securities Act to evaluate his investment risk, the fact that the variable annuity also has certain insurance features does not bring it within the exemption of Section 3 (a) (8). The insurance features are (1) the five-year diminishing term insurance and the premium waiver provision often sold with the variable annuity and (2) the mortality factor during the pay-out period of the variable annuity contract now being sold. As to the

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[31] Crobaugh, *Annuities and their Uses* (1933), p. 25. Authorities cited by respondents in the courts below are in accord with this definition. See Jordan, *Life Contingencies*, pp. 50–52; *Proceedings of the Casualty Actuarial Society*, Vol. 23, Part II, No. 28, May 13, 1927, reprinting "The Early History of the Annuity," by Edwin H. Kopf; Pitman, *Dictionary of Life Assurance* (1930), p. 61.

first, we note that only a very small percentage of the investor's payments is allocated to term insurance or premium waiver (p. 8, *supra*), that diminishing term insurance may also be a feature of the periodic payment plans (R. 110 and see p. 22, *supra*); and that the courts below found "to be irrelevant" the fact that term insurance was sold (R. 888 and see R. 83–84. The mere fact that a company may be incidentally selling insurance does not make it an insurance company. Cf. *Bowers* v. *Lawyers Mortgage Company*, 285 U. S. 182, 190, where this Court held that the issuance of guarantees constituted an insurance business, but that where this was merely an incidental part of a company's business the company cannot be considered an insurance company within the meaning of the Internal Revenue Code.

As to the fact that payments during the pay-out period must be continued throughout the the purchaser's life, the contracts purportedly seek to remedy not only the problem that an individual, who has accumulated savings, may find that over the years these have been reduced in value by reason of a higher price level, but also the problem that he might outlive any periodic withdrawal of his savings. The second problem cannot be satisfactorily solved, however, if in an attempt to solve the first the savings can be lost or seriously diminished through unsuccessful common stock investments. Thus, although as VALIC points out (Br. in Opp. 16), the traditional annuitant "prospers when he outlives his expectancy," it is possible that the holder of a variable annuity who outlives his life

expectancy could lose in the event of his company's having an unsatisfactory investment experience. Accordingly, even if the insurance aspect could be separated from the investment aspect and were considered of equal importance, to paraphrase the language of the committee report, quoted in the *Ralston Purina* case at p. 39, *supra,* there would still be a "practical need" for the protections of the Securities Act—that is, the investor's need for full information as to the nature of that investment risk—and, hence, the Act must be held applicable.[32]

During the accumulation period, which presumably is the longer period during which the contract is in existence, the death of the purchaser will not affect the value of his participation in respondents' portfolio of securities. As the District Court found (R. 108):

> 59. No mortality features are involved in the calculation of the number of "accumulation units" or their value.
>
> 60. During the first 5 years there is a mortality consideration only with respect to a small portion of the premium paid during that period, and then only if the contract holder has the

[32] It should be noted in this connection that, as pointed out at page 7, *supra,* until the Commission instituted the present action one of the contracts sold by the respondents had an optional provision for payment solely for a definite number of years without any reference to the death or survival of the purchaser. This indicates that the respondents themselves have not considered the mortality factor essential, and that their primary purpose is to induce members of the public to entrust their money to the respondents for investment as a hedge against inflation. Purchasers are still investing under plans containing the option which involves no mortality feature.

five-year term insurance or the disability premium waiver.

During the accumulation period, the purchaser is entitled to redeem his units at their then current value, that is, he can cash in his aliquot share of respondents' portfolio. If he should die, his beneficiary or his estate receives the identical value of his participation, either in cash or through an alternate option presumably of the same value. Since the pay-in period of the contract is separable at the will of the purchaser from the pay-out period (R. 108) and since during the former period it does not differ in any essential characteristic from an ordinary contract for the periodic accumulation of investment company shares (see pages 19–27, *supra*), it should not be exempt from registration under the Securities Act, whatever the determination with respect to the pay-out period.

Application of the Securities Act does not prevent states from also exercising jurisdiction. Indeed, Section 18 of the Act (15 U. S. C. 77r) specifically contemplates concurrent regulation by the Securities and Exchange Commission and by state securities commissions, some of which have jurisdiction over insurance. See *Travelers Health Association* v. *Virginia,* 339 U. S. 643, 653.

The courts below placed great emphasis on the fact that the Superintendent of Insurance of the District of Columbia has licensed the respondents to do business in the District. Both courts also noted similar action by other state authorities. R. 90–91, 890. However, this licensing, by itself, cannot be deter-

minative of the question of whether the contracts are exempt under Section 3 (a) (8) of the Securities Act. To be sure, regulation of the issuing company by an insurance commissioner is one condition precedent to the exemption of insurance or annuity contracts from the federal securities commission's jurisdiction.[33] But it still must be found that insurance or annuity contracts are really involved, and the federal legislation does not refer that determination to the local authorities.[34] Whatever weight the courts should accord to the opinions of local authorities, their judgment should not be given precedence over the interpretation adopted by the Securities and Exchange Commission, the authority set up by Congress to administer the Act.[35]

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[33] The exemption under Section 3 (a) (8) of the Securities Act requires first a determination that the instrument involved is an "insurance or endowment policy or annuity contract or optional annuity contract" and then, as an additional qualification, that it be "issued by a corporation subject to the supervision of the insurance commissioner * * *."

[34] If the exemption had read "any contract sold by a company licensed to sell insurance by any state authority" or "any security determined to be insurance by any state authority", then the granting of the license or the determination by the Commissioner would of itself have been the determinative factor. On such a basis, securities issued or guaranteed by any state are for that reason, without more, exempt. Section 3 (a) (2); 15 U. S. C. 77c (a) (2). On the other hand, the statute, as enacted, conditions the exemption of insurance upon the action of the state agencies, but does not make such action determinative.

[35] *Securities & Exchange Commission* v. *Associated Gas & Electric Co.*, 99 F. 2d 795 (C. A. 2); cf. *United States* v. *Allen-Bradley Co.*, 352 U. S. 306; *National Labor Relations Board* v. *Denver Building Council*, 341 U. S. 675; *United States* v. *American Trucking Associations, Inc.*, 310 U. S. 534.

Moreover, state authorities differ sharply as to the nature of variable annuities. A poll of thirty-seven states made in 1957 by the National Association of Securities Administrators indicated that insurance commissioners are about evenly split on the question whether or not to approve the variable annuity for sale as insurance, while the securities commissioners are almost unanimous in their opinion that the variable annuity is a security.[36] The only court decision concerning a contract which is substantially identical to the variable annuity contract is *Spellacy* v. *The American Life Insurance Association,* 144 Conn. 346, 131 A. 2d 834 (1957).[37] That case dealt with a "vari-

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[36] 1 C. C. H. Blue Sky Report, Para. 4,711.

[37] The court described the contract there involved as follows (131 A. 2d at p. 839):

"Upon the exercise of this option, the defendant agrees to grant a variable annuity certificate, or policy, for any one of five types of annuity payments. The variable annuity policy is to be issued 'for such total number of variable annuity units, payable monthly or as may be agreed, as the cash redemption value of the accumulated variable endowment units * * * shall purchase at the initial conversion value of the Variable Annuity Units in effect when the [policy] is issued.' A minimum is fixed at 1000 variable annuity units. The endowment policy recites that '[t]he objective of the contract for Variable Annuity Certificate will be the preservation and increase of the relative purchasing power of the initial dollar value of the annuity units.' In line with this objective, the dollar return from the annuity units would fluctuate with the value and the amount of return from the corpus of the fund from which the annuities are paid."

An "Estate Builder" contract, having certain features of the variable annuity contract and using insurance terminology was held to be an attempt to sell an investment as insurance in *Coastal States Life Insurance Company* v. *Kelly*, Court of Common Pleas, Richland County, So. Car., June 1955, unre-

able endowment" contract with a "variable annuity" option at the maturity date. The court stated (131 A. 2d at p. 839):

> The policy to be issued under the annuity option would provide for the payment, not of a fixed amount of money, but of an uncertain sum, which is quite different from the legal concept of the word "annuity." Here again, the legislature employed a term generally used and understood, and it must be assumed that it did so intending that annuity payments should be in definite sums of money.

The court recognized that the dollar might depreciate, but stated that whereas such depreciation was an economic risk which an insured ran, the person payable in the dollar value of units ran not only economic risks but also the risk of depreciation from factors other than economic. It stated (p. 840):

> There is a real distinction, however, between the general depreciation in the value of the dollar and the depreciation which may occur in the value of units in a variable endowment or annuity fund such as is contemplated in the present case. The former is due to widespread economic factors affecting all alike. The latter may be due to such factors, reflected in a general decline in the market value of securities

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ported. On July 21 and 22, 1958, there was a trial in West Virginia on a complaint for injunction instituted by the Securities Commissioner of that State to prevent VALIC from selling their contracts in violation of the securities laws of West Virginia. No decision has been rendered in that action as yet. *State of West Virginia* v. *Variable Annuity Life Insurance Co.*, Circuit Court of Kanawha County, W. Va., Docket No. 24,449.

rather than in the depreciation of the dollar, but it may also be due to possible poor judgment or lack of skill in the management of the investments in the particular fund. When an endowment or annuity is payable in a specified number of dollars, an insured runs the risk of depreciation of the dollar. When it is payable in variable endowment or annuity units, he runs the risk of depreciation of the unit, measured in dollars, including the added risk that it may be depreciated by reason of factors not traceable to general economic conditions. The defendant escapes this type of risk and transfers it to the insured.

Accordingly the court held that the contracts involved were not insurance or annuity policies and could not be issued by insurance companies.

In view of the difference in approach by the insurance agencies in the District of Columbia and Connecticut, what should be the status of contracts approved as insurance in one state and disapproved in others? Since, under Section 3 (a) (8) of the Securities Act, supervision by *any* state commission suffices to provide an exemption, investors of the states which do not treat the contracts as insurance would, if licensing by one were determinative on the question of whether the contract constitutes insurance, be deprived of the protection of the federal law by reason of the interpretation of some other state. This is contrary to the entire notion of the Securities Act. See Message of President F. D. Roosevelt to Congress dated March 29, 1933, reprinted in S. Rep. No. 47, 73d Cong., 1st Sess.

Whatever interpretation might be placed on the variable annuity contracts in other contexts, they are almost classic illustrations of the type of instruments which should be registered in order to afford the purchaser the full protections intended by the Securities Act. The potential evils at which the statute is directed are most apparent when the security represents an equity interest in a corporation or represents an interest in a pool of common stocks which themselves represent equity interests in many corporations. Under such conditions the security depends for its value upon so many factors which may be unknown to the investor that all pertinent financial facts should be disclosed to the investor if the remedial purpose of the statute is to be effectuated.

C. THE RESPONDENTS ARE NON-EXEMPT INVESTMENT COMPANIES UNDER THE INVESTMENT COMPANY ACT OF 1940

The Investment Company Act of 1940 defines an investment company as an issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities" (Section 3 (a) (1); 15 U. S. C. 80a–3 (a) (1), App. A, *infra*, p. 65); or as an issuer which "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets * * *" (Section 3 (a) (3); 15 U. S. C. 80a–3 (a) (3)). There can be no question but that the respondents are engaged in the business of investing, reinvesting, own-

ing, holding and trading in securities. It is by means of this investment and reinvestment that they purport to enable the purchasers of the contracts to keep pace with the cost of living (R. 86). It is around this investment and reinvestment that all of their operations, other than sales, are centered. An investment adviser is employed and featured in their sales literature (R. 758). Their assets consists almost exclusively of investments in securities. The success or failure of the company will depend largely upon the success or failure of its investment experience.

Respondents contend, however, that they are not required to comply with the registration provisions of the Investment Company Act by reason of Section 3 (c) (3) (15 U. S. C. 80a–3 (c) (3), App. A, *infra*, pp. 65–66), which excepts from the definition of investment company "[a]ny bank or insurance company; * * *" An insurance company is defined by Section 2 (a) (17) of the Act (15 U. S. C. 80a–2 (a) (17), App. A, *infra*, p. 66) as a "company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; * * *"

These definitions, like the definitions in the Securities Act of 1933 discussed above, must be construed in the light of the "dominating general purpose" of the Act (see p. 35, *supra*). Section 1 (b) of the Investment Company Act (15 U. S. C. 80a–1 (b)) states

that the Act was designed "to mitigate and, so far as is feasible, to eliminate" previously existing abuses, including *inter alia* misleading sales methods and inadequate information as to the company's investment policies. As we have seen in Point I, A, *supra*, the legislative history of this Act is replete with references to the need for legislation for periodic payment plans by reason of their characteristics identical to those of the variable annuities.

In Point I, B, *supra*, we have shown that the contracts sold by appellees are securities. The business of appellees, therefore, is primarily and predominantly that of selling securities and investing and reinvesting the proceeds from those sales for the benefit of the security holders. Such insurance as may be sold in connection with the sale of the security (see p. 7, *supra*) plays so small a part in the scheme and purpose of respondents' activity that it cannot be considered their "primary and predominant business activity."[38] That the Act contemplates that securities sold by a registered investment company

[38] The only case decided by an appellate court where it was claimed that a company was entitled to an exemption from the definition in Section 3 (a) of the Investment Company Act is *Bankers Securities Corp.* v. *S. E. C.*, 146 F. 2d 88, 92 (C. A. 3). The court there stated that the Commission was "justified in and required to take the sum total of the activities" of the person claiming the exemption in reaching its determination whether that person was subject to the Investment Company Act. In that case it was contended that the petitioner, which had substantial interests in department stores and in real estate, was not "primarily engaged" in the business of investing and reinvesting in securities. The court upheld an order of the Commission denying the application for an exemption.

may include insurance features is clear from Section 28 (a) (2) (G) (15 U. S. C. 80a–28 (a) (2) (G)), which requires certain investment companies to maintain "such appropriate contingency reserves for death and disability benefits * * * on any such certificate providing for such benefits or rights as the Commission shall prescribe by rule, regulation, or order based upon the experience of face-amount companies in relation to such contingencies."

Not only do the respondents fall technically outside the exemption for insurance companies, but also the basic economic factors relating to respondents' business differ substantially from those relating to insurance companies. An insurance company has to meet fixed obligations and will be insolvent if its investment policy is such that the insurance obligations cannot be met. Therefore, there is great economic pressure to invest conservatively. Respondents, however, are under no such pressure, since payment on variable annuities is made without reference to fixed dollar obligations. It is true that increased sales with resulting profits to the company would result from successful operation, but the chance of spectacular success through speculative investment policies might sometimes outweigh considerations of safety.

The fact that a company is subject to the Investment Company Act does not preclude state regulation of its contracts. Section 24 (d) of the Investment Company Act (15 U. S. C. 80a–24 (d), App. A., *infra*, p. 67) provides that the exemption in Section 3 (a) (8) (15 U. S. C. 77c (a) (8)) of the Securities Act, relating to

insurance policies, "shall not apply to any security of which an investment company is the issuer." This necessarily contemplates dual regulation by an insurance commissioner and the Securities and Exchange Commission in the situation where an investment company sells insurance policies, since the exemption of Section 3 (a) (8) is applicable only to policies subject to state regulation (see p. 44, *supra*). Finally, Section 50 (15 U. S. C. 80a–49, App. A, *infra*, pp. 67–68) provides that nothing in the Act shall affect the jurisdiction "of any State or political subdivision of any State, over any person, security, or transaction, insofar as such jurisdiction does not conflict with any provision of this title or of any rule, regulation, or order hereunder."

For the reasons pointed out in our discussion of the exemption under Section 3 (a) (8) of the Securities Act (pp. 43–47, *supra*), the fact that state authorities may consider the respondents to be insurance companies is entitled to less weight than the views of this Commission in construing the exemption for insurance companies contained in Section 3 (c) (3) of the Investment Company Act. State insurance commissioners are presumably interested in overseeing any insurance functions being performed by companies within their states and it is not to be expected that they will refuse to accept a proffered submission to their jurisdiction. Particularly in view of the dual regulation contemplated by the federal securities acts, this acceptance of regulation by the state commissioners should have no bearing on the determination

of this Commission or of the federal courts whether a company is within the scope of an Act of Congress requiring regulation for the protection of investors. VALIC in its brief in opposition to the petitions for writs of certiorari (pp. 17–18) states that regulation by this Commission under the Investment Company Act would result "in the *utter destruction* of VALIC" because of (a) a prohibition in Section 18 (f) of the Act against an open-end investment company having outstanding a security of any class which has a priority over any other class in assets or dividends and (b) a prohibition in Section 18 (a) of the Act against a closed-end investment company issuing a debt security unless such security has an asset coverage of 300 percent. Whether or not these sections would "bar" the issuance of VALIC's contracts, as contended, the argument amounts only to the proposition that, because VALIC seeks to solve an economic problem, it must be allowed to operate in a manner that does not comply with the standards Congress has deemed necessary for the protection of the public and investors. If federal regulation of these contracts is comprehended by the federal securities acts, that regulation may of course alter the methods by which the respondents are doing business.[39] Actually, however, the impediments to compliance with the Investment Company Act do not appear as basic as the respond-

[39] By Section 6 (c) of the Act (15 U. S. C. 80a–6 (c)), the Commission is given authority to grant exemptions from any of the provisions of the Investment Company Act on a finding that exemption is "necessary or appropriate in the public interest."

ents imply. The fundamental features which are asserted to characterize variable annuities, that is, payments for the duration of the life of the purchaser which vary in amount to reflect changes in the value of the company's portfolio, do not appear antagonistic to the provisions of the Investment Company Act, even though the respondents would have to alter their structure and the provisions of their present contracts to comply with some of the Act's provisions.

II

THE M'CARRAN-FERGUSON ACT CREATES NO EXEMPTION FROM THE FEDERAL SECURITIES ACTS FOR RESPONDENTS OR FOR THE VARIABLE ANNUITY CONTRACTS WHICH THEY SELL

The respondents and the courts below relied not only on the insurance exemptions in the Securities Act and the Investment Company Act, but also on the McCarran-Ferguson Act (15 U. S. C. 1011–1015), Appendix A, *infra,* pp. 68–69, which was passed by Congress in 1945 to overcome the holding of this Court in *United States* v. *South-Eastern Underwriters Association,* 322 U. S. 533. This Court had held that insurance was commerce and that the antitrust laws were applicable to it. The 1945 statute declared "that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States." 15 U. S. C. 1011, Appendix A, *infra,* p. 68. The explicit provisions of the Act are discussed below.

The basic reason why the McCarran-Ferguson Act has no effect on the federal securities acts in this case is the same which we have discussed in Point I, namely, that the contracts here involved are not insurance and the respondents are not primarily engaged in the insurance business. If the term "business of insurance" in the McCarran-Ferguson Act goes no further than the insurance exemptions of the Securities Act and the Investment Company Act, then its application can have no bearing on the present case; the exemption will exist under all three acts or under none. On the other hand, to construe the term "business of insurance" to have a broader scope than the exemptions in the prior acts would require the assumption that Congress, without giving specific consideration to the legislative purpose of the securities acts or the need of purchasers for the protections afforded thereby, had amended those acts *pro tanto,* a result wholly contrary to the legislative history and purpose of the McCarran Act.

Actually, there is no basis for the assumption that Congress meant by insurance anything different in one statute from the others. All of the arguments which we present above, on the basis of an analysis of the nature of the variable annuity contracts here involved, to show that they are not insurance are equally applicable for the present point. And the possibility of determining the issue on the basis of decisions by individual state insurance commissioners is even more unreasonable, since such an interpretation would result in the provisions of the securities law being inapplicable in some states and applicable

in others."[40] Certainly the federal requirements cannot be said to impinge upon the authority of the insurance authorities in Connecticut, where contracts similar to those here involved have been held not to be insurance, *Spellacy* v. *The American Life Insurance Association*, 144 Conn. 346, *supra*, page 45, merely on the ground that the contrary was held in the District of Columbia by the insurance authorities there.

However, even on the assumption that the respondents are engaged in the "insurance business" within the meaning of that phrase in the McCarran-Ferguson Act, still that Act does not limit the jurisdiction of the Securities and Exchange Commission. As is pointed out above, the purpose of Congress was to counteract the decision of this Court in the *South-Eastern Underwriters* case. To accomplish this end Congress considered that two steps were required.

First, it was necessary to reestablish the States' authority to tax and regulate the business of insurance in spite of the holding that insurance was interstate commerce. This the McCarran Act did by providing that "The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business" and that no act of Congress by its silence or in the absence of specific provision "shall be construed to invalidate, impair, or supersede any

---

[40] The Securities Act exemption, Section 3 (a) (8), 15 U. S. C. 77c (a) (8), provides a total country-wide exemption where the insurance is issued by a company licensed by any state authority.

law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business." 15 U. S. C. 1011, 1012. In terms, these provisions were not a limitation on federal regulation; they merely reaffirmed the states' authority to regulate and to tax. They did not eliminate the possibility of dual regulation. This section of the law was construed by this Court in *Prudential Insurance Company* v. *Benjamin,* 328 U. S. 408, and the power of Congress to permit such state regulation of interstate business was affirmed.

The second facet of the McCarran Act was to provide a moratorium upon the imposition of federal authority, the exercise of which had been upheld in the *South-Eastern Underwriters* case. Here, Congress had a choice. It could have suspended the imposition of all federal regulatory powers when applied to insurance or limited the suspension to the class of regulation which had thrown the insurance companies into confusion as a result of the *South-Eastern Underwriters* case. Congress took the latter course and legislated specifically with reference to the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Act. By 59 Stat. 34, it suspended the application of these laws to insurance until January 1, 1948, and as to the first three it provided that they should apply thereafter only if such business should not then be regulated by state law. In *Maryland Casualty Co.* v. *Cushing,* 347 U. S. 409, this Court had occasion to determine the extent to which federal law had been suspended, the argument being

that because of the McCarran Act the Louisiana insurance law, permitting direct suit against insurers, took precedence over the federal Limited Liability Act, 46 U. S. C. 183. Though there was no opinion for the Court, four of the justices in the majority clearly ruled that the McCarran Act was not to be construed to limit federal regulation beyond the circumstances which led to its enactment. They stated, in an opinion by Mr. Justice Frankfurter, at 413:

> Suffice it to say that even the most cursory reading of the legislative history of this enactment makes it clear that its exclusive purpose was to counteract any adverse effect that this Court's decision in *United States* v. *South-Eastern Underwriters Association,* 322 U. S. 533, might be found to have on State regulation of insurance. * * *
>
> The question whether application of the direct action statute conflicts with federal maritime law is not touched by the *South-Eastern Underwriters* case. In the face of this unequivocal expression of congressional meaning, the statute cannot be read as doing something that Congress has told us it was not intended to do. The McCarran Act is not relevant here.

Although the fifth Justice on the majority, Mr. Justice Clark, did not discuss the application of the McCarran Act, his holding must be construed as indicating that he also did not believe that the Limited Liability Act was altered by the McCarran Act.

The legislative history of the statute fully supports the meaning of its language as so construed. H. Rep. No. 143, 79th Cong., 1st Sess., at page 3 states:

> It is not the intention of Congress in the enactment of this legislation to clothe the States with any power to regulate or tax the business of insurance beyond that which they had been held to possess prior to the decision of the United States Supreme Court in the *Southeastern Underwriters Association* case.

And the same report describes the purpose of the bill as follows:

> The purpose of the bill is twofold: (1) To declare that the continued regulation and taxation by the several States of the business of insurance is in the public interest; and (2) to assure a more adequate regulation of this business in the States by suspending the application of the Sherman and Clayton Acts for approximately two sessions of the State legislatures, so that the States and the Congress may consider legislation during that period. * * *

The only basis on which it could be argued that the McCarran Act wrote an additional exemption into the Securities Act and the Investment Company Act would be by the artificial construction that, insofar as regulation by the Securities and Exchange Commission differs from that of the state insurance commissioner, it would thereby "invalidate, impair, or supersede" the State's insurance laws. But this is not realistic in the light of the specific clauses in both Acts, Section 18 of the Securities Act (15 U. S. C. 77 (r)) and Section 50 of the Investment Company Act

(15 U. S. C. 80a–49), preserving to the state regulatory bodies their jurisdiction. Obviously, the acts are intended by Congress to be complementary, and the securities legislation was not at all intended to invalidate, impair, or supersede the state statutes.

But even if it were asserted on the basis of some unusual construction that somehow the Securities Act and the Investment Company Act did invalidate, impair, or supersede state laws dealing with insurance, still Section 2 of the McCarran Act (15 U. S. C. 1012) saves them since they "specifically relate to the business of insurance." As indicated in the preceding points, there are specific references to insurance in both the Securities Act of 1933 and the Investment Company Act of 1940. Through these references Congress gave expression to the extent to which there might be regulation by the Securities and Exchange Commission over instruments with insurance characteristics and over companies selling such instruments. Thus, Section 3 (a) (8) of the Securities Act, read together with Section 24 (d) of the Investment Company Act, both of which were in effect prior to passage of the McCarran Act, had made it clear that certain insurance policies were not to be exempt from the registration provisions of the Securities Act, *i. e.*, those not subject to the supervision of a state insurance or bank commissioner and those so subject if issued by an investment company. Similarly, Sections 3 (c) (3) and 2 (a) (17) of the Investment Company Act make it clear that a company which is within the definition of an investment company and which is also engaged in the writing of insurance but

not primarily and predominantly so engaged is subject to regulation under the Investment Company Act. See also Section 28 (a) (2). (G) of the Investment Company Act, 15 U. S. C. 80a–28 (a) (2) (G), discussed at page 51, *supra,* and Section 12 (g), 15 U. S. C. 80a–12 (g), which states specifically with respect to restrictions on the purchase of insurance securities by registered investment companies:

> Nothing contained in this section shall in any way affect or derogate from the powers of any insurance commissioner or similar official or agency of the United States or any State * * *.

Presumably, companies selling insurance are generally subject to the regulation of state insurance authorities, whether or not this is their predominant business, just as insurance policies written by an investment company may be under the jurisdiction of state authorities. As we have seen, both state and federal regulation, in certain of these areas, was clearly contemplated by Congress prior to passage of the McCarran Act. This is explicit in Section 18 of the Securities Act and Sections 12 (g) and 50 of the Investment Company Act (see *supra,* pp. 59–60). The McCarran Act, which was enacted to prevent misconstruction of "silence on the part of the Congress", intended no different result.

For the foregoing reasons the judgment of the Court of Appeals should be reversed.

Respectfully submitted.

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DECEMBER 1958.

APPENDIX A

STATUTES INVOLVED

Section 2 (1) of the Securities Act of 1933 (48 Stat. 74, as amended; 15 U. S. C., Sec. 77b (1)) provides:

> SEC. 2. When used in this title, unless the context otherwise requires—
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3 (a) (8) of the Securities Act of 1933 (48 Stat. 74; 15 U. S. C. 77c (a) (8)) provides:

> SEC. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities.
>
> * * * * *
>
> (8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory

of the United States or the District of Columbia;

Section 5 of the Securities Act of 1933 (48 Stat. 77; 15 U. S. C., Supp. II, Sec. 77e) provides:

SEC. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

(2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the reg-

istration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

Section 18 of the Securities Act of 1933 (48 Stat. 85; 15 U. S. C. 77r) provides:

> Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.

Section 3 (a) (1) and 3 (a) (3) of the Investment Company Act of 1940 (54 Stat. 797; 15 U. S. C. 80a–3 (a) (1) and (3)) provide:

> SEC. 3. (a) When used in this title, "investment company" means any issuer which—
>
> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
>
> * * * * *
>
> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.
>
> * * * * *

Section 3 (c) (3) of the Investment Company Act (54 Stat. 798; 15 U. S. C. 80a–3 (c) (3)) provides:

> (c) Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:
>
> * * * * *

(3) Any bank or insurance company; * * *

An insurance company is defined in Section 2 (a) (17) of the Investment Company Act (54 Stat. 790, 793; 15 U. S. C. 80a–2 (a) (17)) as—

> (a) When used in this title, unless the context otherwise requires—
>
> * * * * *
>
> (17) "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

Section 12 (g) of the Investment Company Act of 1940 (54 Stat. 810; 15 U. S. C. 80a–12 (g)) provides:

> (g) Notwithstanding the provisions of this section any registered investment company and any company or companies controlled by such registered company may purchase or otherwise acquire from another investment company or any company or companies controlled by such registered company more than 10 per centum of the total outstanding voting stock of any insurance company owned by any such company or companies, or may acquire the securities of any insurance company if the Commission by order determines that such acquisition is in the public interest because the financial condition of such insurance company will be improved as a result of such acquisition or any plan contemplated as a result thereof. This section shall not be deemed to prohibit the promotion of a new insurance company or the acquisition of the securities of any newly created

insurance company by a registered investment company, alone or with other persons. Nothing contained in this section shall in any way affect or derogate from the powers of any insurance commissioner or similar official or agency of the United States or any State, or to affect the right under State law of any insurance company to acquire securities of any other insurance company or insurance companies.

Section 24 (d) of the Investment Company Act of 1940 (54 Stat. 826; 15 U. S. C. 80a–24 (d)) provides:

> (d) The exemption provided by paragraph (8) of section 3 (a) of the Securities Act of 1933 shall not apply to any security of which an investment company is the issuer. The exemption provided by paragraph (11) of said section 3 (a) shall not apply to any security of which a registered investment company is the issuer, except a security sold or disposed of by the issuer or bona fide offered to the public prior to the effective date of this title, and with respect to a security so sold, disposed of, or offered, shall not apply to any new offering thereof on or after the effective date of this title.

Section 50 of the Investment Company Act of 1940 (54 Stat. 846; 15 U. S. C. 80a–49) provides:

> SEC. 50. Except where specific provision is made to the contrary, nothing in this title shall affect (1) the jurisdiction of the Commission under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, or title II of this Act, over any person, security, or transaction, or (2) the rights, obligations, duties, or liabilities of any person under such Acts; nor shall anything in this title affect the jurisdiction of any other commission, board, agency, or officer of the

United States or of any State or political subdivision of any State, over any person, security, or transaction, insofar as such jurisdiction does not conflict with any provision of this title or of any rule, regulation, or order hereunder.

The McCarran-Ferguson Insurance Regulation Act (15 U. S. C. 1011) provides:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

SEC. 2. (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

SEC. 3. (a) Until June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as

amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, and the Act of June 19, 1936, known as the Robinson-Patman Anti-discrimination Act, shall not apply to the business of insurance or to acts in the conduct thereof.

(b) Nothing contained in this Act shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.

SEC. 4. Nothing contained in this Act shall be construed to affect in any manner, the application to the business of insurance of the Act of July 5, 1935, as amended, known as the National Labor Relations Act, or the Act of June 25, 1938, as amended, known as the Fair Labor Standards Act of 1938, or the Act of June 5, 1920, known as the Merchant Marine Act, 1920.

SEC. 5. As used in this Act, the term "State" includes the several States, Alaska, Hawaii, Puerto Rico, and the District of Columbia.

SEC. 6. If any provision of this Act, or the application of such provision to any person or circumstances, shall be held invalid, the remainder of the Act, and the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected.

APPENDIX B

Assuming the calculation of the value of an accumulation unit and an annuity unit on February 28:

The formula for an accumulation unit is: Pl. Ex. 3–C (R. 632–3) and 3–D (R. 634).

$$\left[\left(\frac{\text{February}^{1}\ \text{Investment Income} + \text{February Realized and Unrealized Capital Gains}^{1} - \text{February Realized and Unrealized Capital Losses}^{1}}{\text{Value of the Investable Assets at the Beginning of February}^{1}}\right) - .0015^{2} + 1.0000^{3}\right] \times \text{Value of the Accumulation Unit at the Beginning of February} = \text{Value of the Accumulation Unit at the End of February}$$

The formula for an annuity unit is: Pl. Ex. 3–C (R. 632–3) and 3–O (R. 644).

$$\left[\left(\frac{\text{January}^{1}\ \text{Investment Income} + \text{January Realized and Unrealized Capital Gains}^{1} - \text{January Realized and Unrealized Capital Losses}^{1}}{\text{Value of the Investable Assets at the Beginning of January}^{1}}\right) - .0015^{2} + 1.0000^{3}\right] \times .9971^{4} \times \text{Value of the Annuity Unit at the Beginning of February} = \text{Value of the Annuity Unit at the End of February}$$

[1] The terms "Investment Income," "Realized and Unrealized Capital Gains," "Realized and Unrealized Capital Losses," and "Value of the Investable Assets" are not defined in the contract and are subject to differing interpretations by accountants and actuaries (Pl. Ex. 3–C, R. 633). No attempt is made here to further define factors.

[2] This constitutes a charge of approximately 1.8% of the "investable assets" per year. There has been no explanation as to the reason for this charge; however, it appears to be similar to the "management fee" charged by many investment companies.

[3] This factor is added so that the calculation will be expressed as a percentage of the unit value at the beginning of the month.

[4] This figure is a reduction factor which neutralizes the effect of using an annuity table based on an assumed 3.5% interest in order to pass on to the purchaser the risk of variation from the assumed rate of interest. See footnote No. 7, page 7, *supra*.

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Reply Brief for the Petitioner

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In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 290

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

REPLY BRIEF FOR THE PETITIONER

The respondents' briefs make it clear that the basic issue in this case is whether the fact that variable annuity contracts provide for the payment of benefits measured by the life span of the purchasers, in and of itself, makes them insurance under the securities laws and the McCarran Act. It does not help the respondents repeatedly to call themselves insurance companies and to assert over and over again that the contracts are insurance. The respondents are insurance companies only if the contracts they sell are insurance and the contracts are insurance only if their

predominant feature is to assume risks of loss which the purchaser would otherwise bear. And, in fact, the contracts are not insurance since, underlying the provision for spreading the payments over the life span of the purchasers, there is the unpredictable feature of measuring the amount of the payments by the success of the management in placing its funds. This basic feature permeates the entire contract and, therefore, underlies this entire case.

We turn now to several of respondents' points which call for further discussion.

1. *It is not the purpose of the Securities and Exchange Commission to outlaw variable annuities.*

VALIC indicates that the variable annuity is a solution culminating four decades of investigation into the problem of inflation (Br. pp. 39–49), and both respondents argue that regulation pursuant to the federal securities acts would destroy this device (EALIC Br. p. 17; VALIC Br. pp. 51–53). As set forth in our main brief (p. 32), this Commission has no authority or desire to interfere with economic experimentation of the sort represented by the variable annuities. It seeks only to prevent evasion of the conditions designed by Congress for the protection of investors. Concededly, some changes in respondents' methods would be required by application to them of the Securities Act and the Investment Company Act. But plans having substantially similar features to those sold by respondents could be drawn in a manner which would not conflict with the provisions of these laws. Moreover, the Commission could invoke the broad exemptive provisions of the Investment Company Act,

to the extent that it might find them "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of that Act. See Section 6(c) of the Investment Company Act, 15 U.S.C. 80a–6.

2. *The essence of the variable annuity is investment, not insurance.*

As indicated in our main brief (pp. 33 *et seq.*), variable annuity holders have no basic insurance protection; the value of their individual shares varies directly with the success or lack of success of the company's investment program, and, should their savings be impaired as a result of unfavorable investments, there will be no obligation on the companies to make up the loss.[1] Respondents concede that investment risk is not an insurable risk (EALIC Br. p. 9; VALIC Br. p. 34). They argue, however, that investment risk is assumed by purchasers of certain types of insurance and apparently would conclude therefrom that the assumption of investment risk by a purchaser of a contract is an invalid test as to whether the company is required to comply with the Securities Act and the Investment Company Act. We do not contend that the purchaser of traditional insurance assumes no investment risk; our contention is that Congress presumably thought that that risk was of such a comparatively minor character, particularly in view of

[1] We note that VALIC (Br. p. 88) equates its policies to a policy with a token mortality guarantee, thereby apparently conceding that they provide no basic insurance protection by way of mortality guarantee.

state regulation, that there was no need to require compliance with the federal securities laws.

It is true that a mutual insurance company or any traditional insurance company writing "participating policies" (referred to in VALIC Br. pp. 36, 43, 93) may distribute dividends in the nature of a return of premium as a result of profitable operations and that these can come about by reason of a favorable investment return, as well as by reason of a favorable mortality experience or lower expenses than anticipated. A mutual policy holder or a holder of the traditional "participating policy", however, like other purchasers of true insurance, is assured of receiving the face amount named in his policy upon the occurrence of the hazard against which he is insured; this is his basic insurance protection. The primary aim of the investment policy of a mutual insurance company, like that of other true insurance companies, is necessarily to provide that there will be sufficient funds to meet its dollar commitments to its policy holders under any circumstances—and Congress presumably felt that supervision by state insurance commissions would prevent deviation therefrom. The investment policy of a variable annuity company, having no such commitment, may be substantially different. Accordingly, variable annuity holders are entitled to have full disclosure of this investment policy;[2] such disclosure

[2] VALIC's argument (Br. p. 38 fn. 4) that the quality and diversification of an insurer's investments are determined by local statutes ignores the wide range of permissible selections. The section (§ 35–535 of the District of Columbia Life Insurance Act) describing permissible investment covers five printed columns in the D. C. Code and includes *inter alia* small loans, mort-

would result from registration of the variable annuity contracts under the Securities Act of 1933 and of the issuing companies under the Investment Company Act of 1940.

Respondents also point to the Immediate Participation Guaranteed Policies (EALIC Br. p. 10; VALIC Br. pp. 24–25) and the College Retirement Equities Fund (EALIC Br. p. 3; VALIC Br. p. 47). These contracts were not in existence when the federal securities acts were enacted (*id.;* R. 539) and hence they can hardly be used as a standard by which to judge whether contracts are exempt from the Securities Act as insurance, or whether a company issuing them is exempt from the Investment Company Act as an insurance company. The line between insurance and investment has been blurred by the inclusion in modern insurance policies of an increasing number of investment characteristics and borderline contracts are difficult to classify. Where, as with the variable annuity contract, however, the dominant characteristic and primary appeal is clearly the investment in securities, the contract is covered by the Securities Act, even where issued by a company subject to regulation by a state insurance commission. In any event, the CREF and IPG plans are distinguishable from those here involved. The IPG contracts are group pension plans which are paid for only by the employer, while

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gage notes, ground rents and equipment trust certificates. The description of equity securities which may be purchased is so broad that it would presumably include the securities of thousands of companies in the United States and Canada.

the employee, who cannot withdraw the funds, is the beneficiary of a *fixed dollar payment* (Tr. 1179). The fact that the employer may pay more or less depending on mortality experience, investment experience, expenses, etc., indicates that this policy, issued presently only to very large groups, is a form of pension plan which is merely administered by an insurance company. The CREF policy on the other hand is closer to the interests here involved, but is issued only in connection with a fixed dollar annuity, and has no surrender rights (R. 483).

VALIC urges (Br. pp. 75, 76) that it is not issuing securities because the District Court made no specific finding that its contract holders were engaged in a "common enterprise"—a term used in this Court's discussion of the test of an investment contract in *S.E.C.* v. *Howey Company,* 328 U.S. 293, 301. The lower court did find that "The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund" (R. 111), and "A VALIC and an EALIC contract holder invests money with the respective defendants with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased by VALIC and EALIC with the money invested by the contract holder, and his expectation of profit based upon the efforts of others applies to both the 'accumulation period' and the repayment or variable annuity period" (R. 109–110). These are descriptions of a common enterprise. At any rate, there can be no doubt but that, under any definition, the investment of funds

for the common benefit of all variable annuity contract holders is a "common enterprise." A single management supervises and directs the investment activities for all the contract holders and each contract holder prospers or suffers in direct proportion to the success or failure of the investment of the group funds. This is the essential characteristic of the variable annuity, and this is the essence of a "common enterprise." It is not affected by the fact that during the pay-out period there will be differences between the interests of individual investors based upon their mortality. There were also differences among the holders of the securities involved in the *Howey* case and in *S.E.C.* v. *Joiner Leasing Corp.*, 320 U.S. 344, to which VALIC also refers.[3]

Respondents point to language in the House Report on the Securities Act (EALIC Br. pp. 22–23; VALIC Br. p. 94) to the effect that "insurance policies are not to be regarded as securities subject to the provisions of the act" since they are not "regarded in the commercial world as securities offered to the public for investment purposes." It is, of course, unnecessary

[3] *Howey* involved a security which consisted of a deed to a specific tract of land together with the offer of a service arrangement under which profits were on an individual basis. As noted by the Court of Appeals in that case, "each purchaser looked for the income from his investment to the fruitage of his own grove and not to the fruitage of the groves as a whole," and individual purchasers were required to pay for replacement of dead trees and other services where required. *S.E.C.* v. *Howey Co.*, 60 F. Supp. 440, 441, affirmed, 151 F. 2d 714, 717 (C.A. 5).

In *Joiner*, each purchaser had an individual leasehold and looked for his profits from expected appreciation therein should a successful well be drilled.

for this Court to determine whether or not traditional insurance policies, which, as we have seen, involve comparatively little investment risk, fall within the definition of Section 2(1) of the Act,[4] since it is clear that the variable annuity contract is an "investment contract" and a "certificate of interest or participation" in a "profit sharing agreement" within the meaning of that definition. See our main brief, pp. 35–38.

EALIC urges (Br. p. 27, and cf. VALIC Br. 96–97) that *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119, does not support our statement that the need of a purchaser of a variable annuity for information with which to assess his investment risk is important in determining whether the variable annuity is exempt from registration under the Securities Act. It points out that *Ralston Purina* dealt with Section 4(1) of the Act, "exempt transactions," rather than Section 3 of the Act, which deals with "exempt securities," and which is here involved. But the language we quoted from *Ralston Purina* to the effect that the applicability of an exemption from the Se-

[4] The ambiguous language of the legislative history by no means compels the determination that insurance be excluded from the definition of a security in Section 2(1) of the Act. *Haberman* v. *Equitable Life Assurance Society*, 224 F. 2d 401, 225 F. 2d 837 (C.A. 5), certiorari denied, 350 U.S. 948, cited by respondents (EALIC Br. p. 18; VALIC Br. pp. 78–79) for the proposition that an annuity is not a security, as we noted in our original brief (p. 37, fn. 28), dealt with an ordinary annuity and, moreover, did not involve the federal Securities Act. Similarly, the other cases VALIC cites on this point (Br. p. 79) deal only with annuities with no variable feature and involve state statutes rather than the Securities Act.

curities Act depends on whether the particular class of persons affected needs the protection of the Act (p. 39 of our main brief) in turn quoted from the legislative history of the Act, and that quotation, *i.e.*, "there is no practical need for [the bill's] application," referred not only to exempt transactions but also to exempt securities.[5]

3. *Local insurance codes do not give variable annuity purchasers the protections necessary for investors.*

As pointed out in our main brief (p. 44), the determination of whether a contract is exempt under Section 3(a) of the Securities Act or whether a company is not an investment company by reason of its being primarily an insurance company within the meaning of Section 2(a)(17) of the Investment Company Act is not made dependent upon the decision of local authorities.[6] Nor would the fact that a particular local jurisdiction might have protections analogous to those of the federal securities acts be determinative. We note, nevertheless, that the re-

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[5] The House Report, from which the *Ralston Purina* opinion quotes, states: "[The bill] carefully exempts from its application *certain types of securities* and securities transactions where there is no practical need for its application or where the public benefits are too remote." H.R. Rep. No. 85, 73d Cong., 1st Sess., 5. (Emphasis supplied.)

[6] The *Union Guarantee and Mortgage Company* case, 75 F. 2d 984 (C.A. 2d), certiorari denied, 296 U.S. 594, cited by EALIC (Br. p. 26) for the proposition that Congress "delegated to the states the power to define 'insurance' and 'annuity'" has no application here. It deals with Section 77B of the Bankruptcy Act.

spondents point to no such local regulation. They cite at length the powers granted to the District of Columbia Superintendent of Insurance (EALIC Br. pp. 33–37; VALIC Br. pp. 58–64), but these differ widely from the disclosure and liability provisions of the Securities Act and the detailed protection against insider profits and inequitable practices of the Investment Company Act.

The District of Columbia Life Insurance Act illustrates that local regulation of insurance is patently not adapted to regulation of the investment aspects of the variable annuity. The sale of investment contracts or other securities is prohibited thereunder in connection with the sale of an insurance policy (Section 35–713), and, accordingly, the sweep of its protections does not extend to those necessary for persons who are primarily purchasing units in a portfolio of common stocks. The disclosure standards referred to by respondents, for example (EALIC Br. p. 35; VALIC Br. p. 59), contain no requirement for the delivery to variable annuity purchasers of a prospectus containing detailed specified information considered necessary for investors, as required by Sections 5(b)(2) and 10 of the Securities Act, 15 U.S.C. 77e(b)(2) and 77j. Nor do the requirements of the District of Columbia insurance code meet the situations where the "national public interest and the interest of investors are adversely affected," that are enumerated in Section 1(b) of the Investment Company Act, 15 U.S.C. 80a–1(b), and toward the mitigation and, so far as possible, the elimination of which all provisions of that

Act are to be interpreted. There is no equivalent of the requirements, *inter alia,* of Section 8 of that Act, 15 U.S.C. 80a–8, for the adoption of fundamental investment policies nor of Section 10, 15 U.S.C. 80a–10, for independent directors. See our main brief, pp. 27–29. Respondents point out that the District of Columbia Superintendent of Insurance may revoke the authority of a company to do business where there is impairment of the capital or surplus and may take possession of the company's property where there is insolvency (EALIC Br. p. 36, VALIC Br. p. 63). These provisions are clearly designed to protect policy holders in a true insurance company by assuring that they will receive the sums they contracted for upon the happening of the contingency against which they are insured. As we have noted, however, substantially all of the savings of a holder of a variable annuity could be dissipated without there being insolvency or possibly any serious impairment of capital or surplus.

4. *The respondents are essentially similar to mutual funds.*

Respondents argue (EALIC Br. p. 14, VALIC Br. p. 15) that the "accumulation units" and "annuity units" do not represent an aliquot share or interest in a fund of securities, despite the findings of the District Court to that effect. Findings of Fact 46, 70; R. 107, 109. Whatever semantic distinction they seek to draw from the situation with respect to a mutual fund, it is clear that each holder of either respondent's accumulation units, like an investor in a mutual fund, is entitled at any time to the value

of a portion of its portfolio which is mathematically computable and which varies directly with the investment experience of the portfolio. Stated more precisely, with respect to either respondent at any given time there can be computed the dollar value of that part of its portfolio which is applicable to the accumulation units and each accumulation unit represents an aliquot portion of that figure; *i.e.*, by dividing that figure by the number of accumulation units, the value of each unit can be computed just as the value of an investment company's share can be computed (R. 725). Respondents' argument that there is no aliquot share is based upon the fact that the overall portfolio of each respondent combines the fund applicable to accumulation units with a fund out of which annuity units are to be paid and which includes sums representing capital and surplus.[1] But even after maturity, the amount received each month by contract holders (*i.e.*, the value of their annuity units) is mathematically determinable and varies directly with the investment experience of the portfolio. See Appendix B to our main brief.

[1] These sums necessarily vary in value not only in accordance with the investment experience of the portfolio, but also in accordance with other factors—*i.e.*, the degree that the actual mortality differs from that anticipated, the annual 1.8% charge, and the amount of dividends to stockholders or additional contributions to capital.

VALIC (Br. pp. 16–18) points to the structure of United Funds, Inc., which was set up to comply with the requirements of the Investment Company Act and contrasts it with its own. In our main brief (p. 31–32), we had referred to this company as one of "numerous open-end investment companies, whose shares represent interests similar to the respondents' accumulation units and whose methods of valuation of these shares is basically the same as the method followed by respondents in valuing the units they sell." We had noted that United Funds, Inc., also sold insurance in connection with its plan and had pointed out that in some states and the District of Columbia its salesmen were required to be licensed as insurance salesmen. VALIC's discussion and chart of the United Funds organization, when analyzed, highlights the similarity of United Funds to VALIC. VALIC, so far as the accumulation period of its contracts is concerned, merely combines the functions of underwriter, fund, and manager in a single organization. For example, VALIC, instead of the underwriter, sells, deducts commissions or sales expenses, and remits the net proceeds for the purchase of interests in its portfolio which are equivalent to shares of United Funds. Instead of the Fund paying 0.5% per year to the investment manager (VALIC) (R. 17),

the VALIC management annually charges 1.8% per year. Like the investment manager and underwriter of United Funds, VALIC's management, as underwriter and manager of its portfolio, receives its sales load and the 1.8% charge, no matter whether the portfolio appreciates or depreciates in value.

VALIC indicates (Br. p. 20) that it is impossible to compare its sales load with that of investment companies because the sales load of investment companies "pays none of the investment trust's operating expenses." This is not accurate. The figures VALIC uses in its brief (pp. 19–20) show that, if VALIC were to sell a contract for an aggregate of premiums totaling $30,000, this would produce a net investment of $26,745. Its sales load (charges other than for life insurance benefits) would be $600 for taxes and $2,550 for other purposes, totaling $3,150 or 10.5% of the gross investment. On the other hand, if United Funds were to sell a contract grossing $30,000, it would only be allowed to charge 9% thereof,[a] or $2,700,[b] thereby producing a greater net investment. It is true that United Funds would make an additional charge of approximately 0.5% per year (VALIC Br. p. 17) to pay the operating expenses of the fund. But

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[a] Section 27 of the Investment Company Act, 15 U.S.C. 80a–27.

[b] United Funds' actual sales charge is 38% for the first year and 1% thereafter (R. 340–341). This would equal on the plans sold by the United Funds 5.625%. Compare this with VALIC's 52% the first year and the percentages decreasing from 12 to 8 in the later years. (See our main brief, p. 4, fn. 3.)

this makes the comparison above no less valid, since VALIC makes a comparable charge of 1.8% per year.[10]

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[10] The respondents' charges of misstatements in our main brief are unjustified. EALIC (Br. p. 11) contends that we have misstated the case with respect to Advisers Fund, Inc., in asserting that purchasers of its periodic payment plans would obtain an annuity at maturity based upon a mortality table guaranteed at the inception of the plan (Br. p. 32); it is pointed out that the insurance company there involved "reserves the right to withdraw the offer or modify the rates or other terms of the commitment * * *" But this is only in connection with the sale of future shares. The balance of the sentence from which VALIC quotes demonstrates that reservation of the right to withdraw is "with respect only to the proceeds from liquidation of shares acquired subsequent to due written notice sent to the affected stockholders * * *" (R. 808)

VALIC's unsupported charge (Br. p. 91) that we misstate the facts and holdings of *Coastal States Life Insurance Company* v. *Kelly* (Court of Common Pleas, Richland County, So. Car., June 1955, unreported) is completely baseless. So is its charge (Br. p. 37) that we erred in summarizing the testimony of the expert witness to the effect that the variable annuity cannot insure against investment risk; indeed, we footnoted the exact statement of the witness. See our brief, p. 35, fn. 26.

Despite a reference to "numerous errors in the SEC Brief" (VALIC Br. p. 37, fn. 2), these are the only specific charges of errors made by VALIC except for a contention (Br. p. 68) that we improperly represented that Section 18 of the Securities Act, 15 U.S.C. 77r, and Section 50 of the Investment Company Act, 15 U.S.C. 80a–49, permit regulation of respondents by state regulatory commissions as well as by this Commission. While it is true that Section 18 of the Securities Act refers specifically to state securities commissions, Section 50 of the Investment Company Act provides that nothing therein shall "affect the jurisdiction of any other commission, board, agency, or officer of the United States or of any State or political subdivision of any State, over any person, security, or transaction, insofar as such jurisdiction does not conflict with any provision * * *" of that Act or rule, regulation, or order thereunder. It is clearly not limited merely to state securities commissions.

CONCLUSION

For the reasons stated in our main brief and in this reply brief, we believe the judgment of the court below should be reversed.

Respectfully submitted.

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VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA and THE EQUITY ANNUITY LIFE INSURANCE COMPANY,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT.

BRIEF FOR *AMICI CURIAE* IN SUPPORT OF RESPONDENTS.

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BRIEF FOR *AMICI CURIAE.*

Statement of Interest.

The Mutual Life Insurance Company of New York and State Mutual Life Assurance Company of America, are mutual life insurance companies, each licensed by and doing business in all of the States and the District of Columbia. Their principal business for more than 100 years has been the issuance of life insurance and annuities.

The interest of these companies in this litigation is in having the issuance of variable annuities recognized as a proper insurance function so that such contracts, in both individual and group forms, may be developed within the same framework of State legislation and regulation as that applicable to all other life insurance contracts.

The Question Presented.

The question presented in this case is whether the sale to the public of variable annuity contracts—that is to say, contracts the reserves for which are supported by investments primarily in equities, with the amounts of the annuity payments varying with investment experience—are subject (a) to the Federal system of securities regulation, (b) to the State systems of life insurance regulation, or (c) to both systems. Petitioner, Securities and Exchange Commission, contends that they should be held subject to the Federal system or to dual regulation by both Federal and State systems.

Argument.

It is respectfully submitted that variable annuities are insurance contracts and that it is in the public interest that, to the extent that variable annuities are offered to the public, they be subject to the comprehensive systems of life insurance regulation provided by the States. It is further submitted that it was not the intent of Congress that dual systems of regulation should be applied.

There can be no question that the variable annuity has, for the reasons stated in respondents' briefs, the unique characteristics of certain life insurance contracts[1]—the liquidation through income payments of a principal sum, together with the investment earnings thereon, exactly over

[1] The variable annuity concept itself recognizes the important distinction that exists between those life insurance contracts which provide for periodic income payments over appreciable, and often very long, periods of time, and those which provide for indemnity. It is only with respect to the former that there is the new emphasis on equity investments.

the human life span, accomplished through the pooling of large numbers of mortality risks. The life insurance business is the only business which employs the highly specialized techniques, under experienced State life insurance regulation and supervision, and requiring trained actuarial knowledge and skills by means of which such contracts, on both an individual and a group basis, can properly be offered to the public.

It is significant that the linking of the annuity principle with equity investments was placed in viable form by Teachers Insurance and Annuity Association[1], the company providing the retirement plans for institutions of higher learning throughout the country. It is also significant that the special enabling legislation for CREF was adopted in as financially knowledgeable a state as New York, a State which has an outstanding record of leadership in life insurance legislation and regulation, and that it placed the operations of the new company under the supervision of the Superintendent of Insurance.

The variable annuity differs from the conventional annuity only in that a materially greater part of the investments supporting its reserves is in equities and annuity payments are contractually keyed to investment experience. This has made necessary the employment of a measure for the periodic payments of annuity income other than a fixed number of dollars, but the periodic income payments are still made through the use of a determinable measure.

The increased emphasis on equity investments is not novel to the life insurance business. Prior to 1950, personal

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[1] Through the formation of a companion company under common management, College Retirement Equities Fund ("CREF"). New York has not yet enacted legislation which would be required to enable domestic life insurance companies generally to issue variable annuities.

trusts limited to "legal" investments in New York were not permitted to make any equity investments. By statutory amendments in that year, up to 35% of such funds may now be invested in equities.[1] The steadily increasing utilization of equity investments in the past quarter century by college and university endowment funds is well known.[2] Funds of religious corporations may now be invested in equities.[3] There has been a significant use of equity investments in funds supporting pension plans which are not funded with life insurance companies.[4] The development in the 1920's and the subsequent rapid growth, particularly since 1940, of mutual investment funds are matters of common knowledge,[5] as is also the growth of the New York

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[1] Chapter 464, Laws of New York 1950, amending the Personal Property Law, Section 21, the Domestic Relations Law, §85, the Banking Law, §100-c, subd. 3, and repealing §111 of the Decedent Estate Law.

See also "A Report by the Trust Investment Study Committee" (New York State Bankers' Association), New York, 1949.

[2] Wood Struthers & Co., *Trusteeship of American Endowments*, 1932.

Scudder, Stevens & Clark, *Survey of University and College Endowment Funds* (1947), pp. 12-13, 19, 24.

"Investing Harvard Money", *Harvard Alumni Bulletin*, pp. 628-634, May 12, 1951.

Guthmann, Harry G., *Institutional Investment and the Problem of Equity Financing*, "Institutional Investments, Law and Contemporary Problems," Duke University, Winter 1952, p. 185.

Vance, Sanders & Company, *A Comprehensive Study of College and University Endowment Funds at June 30, 1957*, Boston Fund, 1957, p. 25.

The Putnam Management Company, *The Harvard Endowment Fund, Research Report*, The George Putnam Fund, Mass. Yearly.

[3] *e.g.*, New York Religious Corporations Law, Sec. 5-a, added by L. 1950, c. 225.

[4] Federal Reserve Bank of New York, *Monthly Review*, December 1953.

Howell, Paul L., *Common Stocks and Pension Fund Investing*, Harvard Business Review, November-December, 1958, pp. 92-106.

[5] National Association of Investment Companies, monthly releases.

Stock Exchange Monthly Investment Plans.[1] There have been changes in laws permitting, to a lesser degree, investments in equities by life insurance companies[2] and even savings banks.[3]

It is respectfully submitted that, as similar changes take place in relation to contracts providing installment income payments based on mortality risks, their essential character does not change. It is further submitted that it is in the public interest that they be offered by life insurance companies. Generally speaking, this would be likely to tend toward a conservative approach to investment questions. It would seem of equal importance, from the standpoint of the public interest, that such contracts be sold by life insurance men in combination with, and as a supplement to, other products of their companies. This would tend to avoid overselling of the equity idea.

Life insurance is a developing business. The payment of policy proceeds through optional annuity and other installment income plans, group insurance and group annuities[4], as well as various forms of business insurance,

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[1] "The Exchange" (New York Stock Exchange monthly publication).

[2] *e.g.*, New York Insurance Law, Sec. 81, subd. 13, added by L. 1951, c. 400, §5; amended by L. 1957, c. 646, §2.

[3] *e.g.*, New York Banking Law, Sec. 235, subd. 26, added by L. 1952, c. 705, §1. See also *Equity Investing by Mutual Savings Banks*, August Ihlefeld (President, Savings Banks Trust Company, New York, 1953).

[4] In the group annuity field, especially under deposit administration, there are many counterparts of the variable annuity in that the insurer may assume less than all the risks assumed under the conventional annuity. For example, there may be no guarantee, or only a limited guarantee, of the rates at which annuities are purchased on the lives of employees at their retirement. Or, some of the elements in the formula on which the rates at retirement are calculated may be specifically left open for adjustment according to the group's future experience, e.g., the insurer's administration expenses, or the insurer's investment experience during the accumulation period.

are only a few examples of such developments. In their initial stages, these were largely experimental, as variable annuity contracts are in their current stage. The others reached their present stage of service to the public under State insurance statutes and, of equal or possibly even greater importance, under the broad supervision of State regulatory authorities experienced in the basic concepts and techniques peculiar to the life insurance business.

Regulated experimentation within this framework is salutary, and the safeguards which it might be expected to supply should be a major factor in the development along sound lines of new or improved insurance functions such as the variable annuity.

Of significance also in this legislative and regulatory area is the role played by the States collectively. The emergence of sound patterns in the new fields has been accelerated by parallel development under generally similar but somewhat differing State statutes and regulations. Thus, similarly regulated experimentation with variable annuities can be expected to cover such matters as the types of equities in which investments may be made, percentage limitations on investments in particular issues, percentage limitations on the amount of voting stock of a single company which an insurer may own, proportion of equity investments which may be held in the reserve, whether variable annuities may be sold alone or only in combination with conventional annuities, conditions of withdrawal during the accumulation period and similar matters.

Congress was aware of the development of the business of insurance in the past under these conditions. It seems clear from the language employed in the statutes under which the Federal system of securities regulation has been established, as well as the McCarran Act, that it was not

the intention of Congress that, as attempts are made to develop new or improved services through products possessing the unique characteristics of life insurance contracts, either the industry or those products should be subjected to dual systems of regulation, State and Federal. The reasons are elaborated in the briefs of respondents.

Conclusion.

It is respectfully urged that the judgment of the Court of Appeals be affirmed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

No. 237

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., *Petitioner,*

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, and THE EQUITY ANNUITY LIFE INSURANCE COMPANY, *Respondents.*

No. 290

SECURITIES AND EXCHANGE COMMISSION, *Petitioner,*

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA and THE EQUITY ANNUITY LIFE INSURANCE COMPANY, *Respondents.*

On Petitions for Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

---

BRIEF FOR RESPONDENT THE EQUITY ANNUITY LIFE INSURANCE COMPANY IN OPPOSITION

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BRIEF FOR RESPONDENT THE EQUITY ANNUITY LIFE INSURANCE COMPANY IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the United States District Court for the District of Columbia are printed at pages 94-112 of the record. The opinion of the District Court is reported at 155 F. Supp. 521. The opinion of the Court of Appeals is not

yet reported but is printed as Appendix A to the Petition of the Solicitor General.

QUESTION PRESENTED

Did the Court of Appeals properly interpret the statutes herein involved and the legislative intent underlying them in holding that, there is "an unmistakable determination on the part of Congress to leave the insurance business in the control of the States until Congress should in plain terms exert its power over some or all aspects of it . . ." and "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance".

STATUTES INVOLVED

The statutes involved are set forth in Appendix B to the petition of the Solicitor General with the exception of the District of Columbia Life Insurance Act of 1934, Title 35, Chapters 3-8 of the District of Columbia Code (1951 Ed.). It is not practicable to set out such Act in this Brief.

STATEMENT OF THE CASE

The undisputed facts of record are that respondents were organized and operate as life insurance companies under the provisions of the District of Columbia Life Insurance Act of 1934 and that they are subject to the supervision of the Superintendent of Insurance of the District of Columbia and the insurance commissioners of other states in which they are licensed to do business. The only business which they are authorized to conduct "shall be restricted to the business of insurance appertaining to persons". Title 35, § 501(d), D. C. Code. It is the regulation of the

"business of insurance" which the McCarran-Ferguson Insurance Regulation Act leaves exclusively to the several states.

The variable annuities issued by respondents have been described thusly

> *A variable annuity contract, . . ., is an annuity contract* under which payments to the annuitant are calculated pursuant to actuarial principles of life contingencies predicated upon an assumed annual investment increment rate in such manner that the annuity payments will remain uniform in dollar amount if actual investment experience conforms to the assumed investment increment rate. The contracts provide that the amount of the payments to the annuitant will vary only to the extent that the actual investment experience varies from the assumed investment increment rate. The amount of such payments to the annuitant prescribed by the contract cannot be decreased by adverse mortality experience or by any increase in the company's expenses in excess of the expense deduction provided for in the policy, but may be decreased by investment losses. (F.F. 30, R. 100-101) (Emphasis supplied).

Participating annuities written by the life insurance industry generally, wherein payments vary in accordance with the Company's investment experience, are described by the District Court

> Under participating annuity policy contracts, the amount of the payments to the annuitant may vary due to the declaration by the insurance company of dividends to the annuitant arising from experience more favorable than anticipated with respect to mortality, investment earnings and expenses. Plaintiff SEC does not contend, neither has it shown, that it has ever instituted any legal or administrative action charging that annuity policies payable in fixed-dollar amounts issued on a participating basis are "securities" under the

Securities Act of 1933, or that the insurance companies issuing such policies are "investment companies" under the Investment Company Act of 1940.
(F.F. 28, R. 100).

No finding of fact by the District Court has ever been challenged by petitioners.

With regard to the Question Presented in this Brief, the District Court held

> In view of the fact that the defendants have been chartered as insurance companies by the District of Columbia and their questioned contracts have been approved by the Insurance Superintendent of the District, and by the insurance departments of certain states, this Court is constrained to hold that the broad, explicit and impelling language of the McCarran Act makes them exempt from Federal regulation unless and until Congress provides otherwise.
>
> * * * *
>
> The Congress, however, has barred all Federal agencies from access to that field, except those specifically named, and SEC has not been named. The broad and exclusive effect of the McCarran Act has been sustained by the Supreme Court and by the Courts of Appeal.
>
> * * * *
>
> At trial, parties, counsel and Court seemed to recognize that there were issues involved in this controversy which would have to be determined by Congress, no matter what decision in this case was made by this or any other court—that Congress might have to provide for new rules and regulations covering variable annuities.
>
> * * * *
>
> It is the judgment of this Court that Congress only can make such contracts and companies amenable to the regulations of SEC.
> 155 F. Supp. 521, 527, 528.

With regard to the Question Presented in this Brief the Court of Appeals held:

> The statutes which we have quoted above show an unmistakable determination on the part of Congress to leave the insurance business in the control of the States until Congress should in plain terms exert its power over some or all aspects of it. The appellants say that, by definition, the business of the appellees is not insurance. We find no such definition. The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance. . . . The new business will need the expert and watchful supervision of these experts in insurance. We think the statutes lodge the responsibility with them.

From the reasoning of both courts below it is clear that a life insurance company, organized and regulated under state laws, and its insurance and annuity policies are exempt from the Securities Act and the Investment Company Act and that Congress has determined that the sole regulation of the company shall rest with the several states.

REASONS FOR DENYING THE WRIT

The petition of the Solicitor General urges three reasons for granting the writ. These will be considered in order.

I

The first reason advanced by the Solicitor General is in essence an assertion that the decision below deprives respondents' policyholders of the protection afforded by the disclosure requirements of the Securities Act.

Regulation of insurance companies and their policies commenced in the United States in 1851. Each state or territory today has a department of insurance which regulates not only domestic companies, but all foreign companies doing business therein. 322 U.S. 533, 584. The nature of the regulation of the business of insurance has been described by the District Court

> The business of insurance is regulated by District and State insurance departments, such regulations among others including (i) control of organization of the company—prescribing minimum capital and minimum surpluses; (ii) regulation of financial structure of the company by regulating valuation of assets, valuation of reserve liabilities and determining investment categories; (iii) regulation of policy forms; and (iv) business methods, that is, regulation and licensing of agents and control of advertising and literature. (F.F. 26, R. 99).

Despite this unchallenged finding the Solicitor General now raises an issue, not raised in the pleadings or at trial, as to the adequacy and efficiency of state insurance regulation in protecting the public through full disclosure of relevant information about a policy.

Disclosure is but one of a number of regulatory devices which insurance regulation utilizes. Insurance regulation does not depend solely upon disclosure but embraces all substantive aspects of the company, its management, its operations and all provisions of its policies. As contrasted with SEC Rule 425, requiring every prospectus to state on its cover that "these securities have not been approved or disapproved by the Securities and Exchange Commission nor has the Commission passed upon the accuracy or adequacy of this prospectus", no policy of insurance may be issued in the District of Columbia until approved for form

and substance by the Superintendent of Insurance. As the Fifth Circuit Court of Appeals has stated, "... the business of insurance has been more generally regulated than any other sphere of business activity not a public utility." *American Hospital & Life Insurance Co.* v. *FTC.*, 243 F. (2d) 719, 721, aff'd 357 U.S. 560.

In enacting the Securities Act of 1933 Congress recognized the need for disclosure concerning securities, the interstate sale of which were theretofore federally unsupervised. Congress was then familiar with the plenary regulation of insurance companies by the several states. In obvious recognition of the fact that insurance and annuities were not considered to be within the intendment of the Securities Act, the House Committee stated that their specific exemption from the Act was included so as to make unmistakable "... what is already implied in the Act, that insurance policies are not to be regarded as securities subject to the provisions of the Act." H. Rept. No. 85, 73rd Cong., p. 15.

The disclosure requirement of the Securities Act is appropriate to the securities field, but serves no useful purpose in the field of insurance where the company, its activities and its products are scrutinized and tested from their inception. The attempt to saddle securities statutes upon life insurance will occasion extensive clashes of regulatory policies and would "take a generation of litigation to determine." 322 U.S. 533, 590.

Regardless of what SEC and the National Association of Securities Dealers now assert to be their purpose in instituting or intervening in the litigation, it is undenied by petitioners that if the Investment Company Act were applicable to respondent, sections 18(f)

and 18(a)(1)(A) of the Investment Company Act would make illegal its insurance business conducted in conformity with District of Columbia law.

II

The second contention advanced by the Solicitor General is that Congress has created a procedure whereby, after a state legislature (or as here, Congress) and an insurance commissioner have authorized a particular insurance policy, that policy and the company issuing it are not perforce exempt from the jurisdiction of the SEC, until the federal judiciary has determined whether such policy is to be considered insurance. (Pet., p. 14).

Such a procedure cannot be found in the language or legislative history of the Securities and Investment Company Acts. Nor can support for such a litigious proposition be found in the McCarran-Ferguson Insurance Regulation Act. The language of that Act precluding the assertion of jurisdiction over insurance companies by federal agencies is clear, and, was intended

> . . . broadly to give support to the existing and future state systems for regulating and taxing the business of insurance . . . by removing obstructions which might be thought to flow from its own power, whether dormant or exercised, *except as otherwise expressly provided in the Act itself or in future legislation. Prudential Ins. Co.* v. *Benjamin,* 328 U.S. 408, 429-430. (Emphasis supplied).

The procedure advocated by the Solicitor General flies in the face of established state-federal relationships and would be an intrusion into the area of state regulation prohibited by the McCarran-Ferguson In-

surance Regulation Act. Such regulatory intrusion by SEC upon established state insurance regulation systems, as admitted by a former SEC Commissioner (R. 402), would make it "probable that in the regulation of the business of insurance by both the federal and state governments there will develop a confict of policies. The parties agree that in such event the federal regulation would control. If so, 'the continued regulation and taxation by the several states,' referred to in Section 1 of the Act as being in the public interest, would no longer exist." *National Casualty Co.* v. *FTC*, 245 F. (2d) 883, 887, aff'd 357 U.S. 560. Indeed, in Nos. 435 and 436, October Term, 1957, the Solicitor General stated that where specific state insurance laws sanction what federal law forbids (and no federal law even authorizes the organization of an insurance company) the mere enactment of the statute renders certain federal laws (presumably all statutes save the three enumerated in section 2(b) of the McCarran Act) inapplicable "for, in that event, there is an obvious collision between federal and state policy and Congress has decreed that state policy should be controlling." Brief, p. 25.

As opposed to the extraordinary procedure for determining the meaning of "insurance" which the Solicitor General proposes, the practicality and wisdom of the existing procedure established by Congress is apparent. Under the Securities Act the test of what constitutes any insurance policy is that it be "issued by a corporation subject to the supervision of the insurance commissioner . . .". Under the Investment Company Act the definition of an insurance company, exempt from the Act, is "a company which is organized as an insurance company, whose primary and predominant business activity is the writing of

insurance . . ., and which is subject to supervision by the insurance commissioner . . ."

There can be no question that respondent is organized as a life insurance company; there can be no question that it has been determined under the D. C. Life Insurance Act as well as by the courts below that respondent's variable annuity policies are insurance; there can be no question that respondent is supervised and regulated by several insurance commissioners; and there can be no question that not only respondent's primary business but respondent's sole business is the writing of insurance according to the law of the District of Columbia. It is submitted that the Court below was correct in holding that

> The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance.

As Congress has said:

> If the States are to be permitted to regulate, they should be permitted to regulate as they see fit. The Committee believe that in considering the nature of the business of insurance, its closeness to policyholders in the several States, the established systems of regulation and control by the States, and the experience and attitude of State insurance commissioners, regulation by the States should not be circumscribed by the establishment of any control over their power of regulation or the exercise by them of that power. H. Rept. No. 873, 78th Cong.

The proposed procedure of determining whether a particular policy issued by an insurance company is "insurance" by submitting the question to the federal judiciary would involve far more than a determination

regarding the particular policies herein. It is the Commission's position (Pet., p. 8)—where an insurance company invests in legally permissible common stocks and its annuity benefit varies with the company's investment experience—then Congress intended SEC to regulate the insurance company. It should be noted that nowhere in the securities acts can be found any delineation between the types of investments or the variations of policies issued by insurance companies.

With regard to the questioned extent of investment in common stocks, the Commission's quarrel is with Congress for enacting § 535 of Title 35 of the District of Columbia Code wherein the legally permissible investments for all domestic insurance companies are set forth in detail. (F.F. 39, R. 106). The bogeyman of possible speculative investments under District of Columbia law, set out on pages 10 and 11 of the Solicitor General's Petition, does not exist and cannot materialize because of the investment limitations of the law. It reflects no credit upon petitioner to advance such an unfounded assertion.

The Commission's position that the distribution of investment experience between Company and policyholder determines its jurisdiction, is likewise without foundation. No such intention of Congress can be gleaned from the reading of the statutes herein involved. The position the Commission is here contending for would presumably require it to assert its jurisdiction over: (1) all mutual life insurance companies (constituting 63% of all life insurance in force)[1] since their policyholders necessarily bear all risks including investment risks (R. 298); in fact, the then senior

[1] Life Insurance Fact Book, 1958, p. 98. Institute of Life Insurance.

governor of the New York Stock Exchange testified that in his opinion every policy issued by a mutual life insurance company is, in part, a security. (R. 391); (2) the variable annuity issued by College Retirement Equities Fund to teachers throughout the United States (R. 480-485); (3) participating annuities issued by most major insurance companies (R. 100); the immediate participation guaranteed (IPG) contracts, where the investment experience of the company is entirely reflected in the accumulated value of the contract, sold by all of the major life insurance companies including Metropolitan, Equitable, John Hancock, Prudential and Connecticut General. (R. 539, 553-554, 561).

Most assuredly a generation of litigation would follow from the extraordinary construction of the law which the SEC espouses.

III

The third reason advanced by the Solicitor General consists of a professed concern as to whether the ruling below will allow mutual funds regulated under the Investment Company Act to "escape the jurisdiction of this Commission." (Pet., p. 18). This result, it is said, would be accomplished by adding an optional annuity provision to a periodic investment plan and thus, mirabile dictu, the mutual funds would escape the jurisdiction of the Commission.

Mutual funds cannot legally concern themselves with life contingencies and such contingencies have no bearing on the value of a shareholder's interest in the mutual fund. Conversely, from the moment respondent issues a policy it has necessarily predicted, through the use of a mortality table, how long the policyholder will live and must calculate the necessary reserve. This prediction and calculation is essential in deter-

mining the amount of future annuity payments to the policyholder. If a group of policyholders live beyond their predicted mortality their payments continue unabated, while respondent must make good its obligations from earnings or capital.

The record is clear that only a life insurance company can offer any contract based on life contingencies (R. 441) and petitioners have never before questioned this fact. It is a legal impossibility for mutual funds to issue an annuity since only a life insurance company can issue an annuity. It is likewise certain that mutual funds are without the purview of insurance statutes and cannot become insurance companies without abandoning their present business in toto.

It is difficult to believe that this phantasmagoria is urged as a reason for granting certiorari.

CONCLUSION

The concurrent findings of both courts below are amply supported by the record and do not warrant further review. The decision below is correct and no substantial issue calling for further review by this Court is presented. The petitions for a writ of certiorari should be denied.

Respectfully submitted,

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September, 1958

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

No. 237

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
Petitioner,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA and THE EQUITY ANNUITY LIFE INSURANCE COMPANY,
Respondents.

No. 290

SECURITIES AND EXCHANGE COMMISSION, *Petitioner,*

v.

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Respondents.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR RESPONDENT VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA IN OPPOSITION

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

No. 237

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,
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Respondents.

On Petitions for Writs of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

---

BRIEF FOR RESPONDENT VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA IN OPPOSITION

The intervening plaintiff NASD and plaintiff SEC[1]

---

[1] ABBREVIATIONS AND EMPHASIS:

Parties: NASD—National Association of Securities Dealers, Inc.; SEC—Securities and Exchange Commission; VALIC—

separately petition for a writ of certiorari, requesting that this Court review the judgment of the United States Court of Appeals for the District of Columbia Circuit (— U.S. App. D.C. —, — F. 2d —, printed NASD Pet. 31-39), which unanimously affirmed the judgment of the United States District Court for the District of Columbia (155 F. Supp. 521, printed R. 82), dismissing with prejudice the SEC complaint against VALIC.

QUESTIONS PRESENTED

In stating their versions of the questions presented, NASD/SEC assume the validity of positions urged by them and rejected by both the District Court and the Court of Appeals. An accurate statement of the questions involved is:

It being undisputed that VALIC is a life insurance company organized under the Life Insurance Act of the District of Columbia and is engaged in the sale of life insurance and variable life annuity contracts with the approval and under the supervision of the Superintendent of Insurance of the District of Columbia and the coordinate insurance administrators of the states in which it operates—

Did the Court of Appeals err in holding that VALIC:

Variable Annuity Life Insurance Company of America, EALIC—The Equity Annuity Life Insurance Company of America.

Record: NASD Pet.—NASD Petition for Writ of Certiorari; SEC Pet.—SEC Petition for Writ of Certiorari; R.—Joint Appendix printed for use of Court of Appeals; F.F.—Findings of Fact of trial court; P. Ex. and D. Ex.—trial court exhibits of plaintiffs or of either defendant.

All emphasis added unless otherwise indicated.

(i) is excluded from the regulatory jurisdiction of SEC by the McCarran-Ferguson Insurance Regulation Act (Act of March 9, 1945, c. 20; 59 Stat. 33, as amended; 15 U.S.C. §§ 1011-1015);

(ii) is not required to register its contracts with SEC under the Securities Act of 1933 (Act of May 27, 1933, c. 38; 48 Stat. 74; 15 U.S.C. §§ 77a et seq.); and

(iii) is not an "investment company" subject to the Investment Company Act of 1940 (Act of August 22, 1940, c. 868; 54 Stat. 789; 15 U.S.C. §§ 80a-1 et seq.).

STATUTES INVOLVED

NASD in Appendix A and SEC in Appendix B of their respective petitions set forth the statutory provisions which they deem pertinent.

The McCarran-Ferguson Insurance Regulation Act is printed in full in Appendix I, pp. 29-30, *infra*.

Also involved is Title 35 of the District of Columbia Code (1951), particularly Chapters 3-8 thereof, being the "Life Insurance Act", hereafter sometimes cited "L.I.A." It is not feasible to reprint this entire title as an Appendix to this Brief.

PETITIONERS' STATEMENTS OF THE CASE

Petitioners' Statements of the Case, largely unsupported by Record references, attempt to translate VALIC's insurance operations into inappropriate securities language (e.g., "investor," "promoter," "shares,") and by this semantic device seek to distort the undisputed evidence, the Findings of the Trial Court, and the Opinion of the Court of Appeals. Respondent cannot accept such a Statement.

RESPONDENT'S STATEMENT OF CASE

I. VALIC is a life insurance company, with corporate authority to engage in—and limited to—the business of insurance[2]

VALIC is a life insurance company, capital and unassigned surplus over $600,000, chartered December 30, 1955, under the Life Insurance Act.

VALIC is authorized by its charter:

> ". . . to engage in the Life Insurance business, *writing life insurance,* [*disability insurance*] *and variable annuities* in combination policies, and for the assumption and ceding of reinsurance written *appertaining to persons as such business is now or may hereafter be regulated by the . . . 'Life Insurance Act,'* . . . .
>
> "As an exemplification . . . the following shall be the business of the Company:
>
> "(a) To grant, purchase or dispose of life [and disability] insurance policies, and variable annuity policies stated in terms of units, the value of which is based in whole or in part on equity type of investments permitted by Section 535 of Title 35 of said 'Life Insurance Act' . . ." (Bracketed material added by amendment.)

The District Insurance Superintendent, acting pursuant to L.I.A. §§ 35-503 and 35-705, approved VALIC's certificate of incorporation and issued its certificate of authority. The District Corporation Counsel on three occasions has certified that VALIC's

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[2] The authorities for this summary of VALIC's operation are F.F. 3-15, 19-21, and 27, R. 94-99; R. 506; D.Ex. 2, R. 406, 814; D.Exs. 6 and 8, R. 406, 817; D.Exs. 13 and 15, R. 406, 823; and D.Ex. 20, R. 406, 832. To avoid prolixity, they are not individually cited.

purpose and corporate structure conform to the District Insurance Law (L.I.A. § 35-503).

The insurance commissioners of West Virginia, Kentucky, and Arkansas likewise have authorized VALIC to transact its business in their respective states.

Each VALIC policy form has the approval of the District Insurance Superintendent (L.I.A. § 35-705) and the insurance commissioner of each state in which VALIC transacts business (R. 506).

In the District and in each state where VALIC operates, statutes provide for detailed supervision of its activities by the insurance authorities. In West Virginia and Arkansas the insurance departments have promulgated regulations specifically applicable to insurance companies offering variable annuity policies. The statutes and regulations assure the most exhaustive supervision by insurance authorities expert in their field.

> ". . . [The] business of insurance has been more generally regulated than any other sphere of business activities not a public utility." *American Hospital & Life Ins. Co.* v. *Federal Trade Commission*, 243 F.2d 719 at 721 (5th Cir. 1957), aff'd *Federal Trade Commission* v. *National Casualty Co.*, — U.S. —, 78 S. Ct. 1260 (June 30, 1958).

II. VALIC's sole business is the sale of life insurance and life annuity contracts.

The variable annuity is an annuity providing a life income, not in a fixed number of dollars, but in variable dollar amounts determined by precise means fixed by the contract, and keyed to the investment results of the insurance company's investable assets.

Variable annuities differ from fixed-dollar annuities only in that the former provide a contractually precise method of relating the insurance company's experience with its investable assets to the annuity benefits payable to the contract holder (R. 471).

Variable annuities provide the annuitant the assurance of a retirement income for life (NASD/SEC expert, R. 281-2); and are "a means of providing a retirement program under which benefit payments tend to vary with cost of living changes" (F.F. 29, R. 100). VALIC's life annuity contract assures the annuitant periodic payments in dollar amounts *and continuing for the uncertain period—long or short—of the life or lives of the annuitant or annuitants* (F.F. 30, R. 100. See also F.F. 29, R. 100).

Variable life annuity contracts are issued, and can lawfully be sold, only by regulated life insurance companies (R. 441). No investment company ever has, or can lawfully underwrite the mortality guarantees that are the annuity's inherent nature.

The District Insurance Superintendent has approved for VALIC eight forms of contracts (F.F. 31, R. 101), seven of which NASD/SEC have ignored throughout this litigation. The seven policy forms ignored by NASD/SEC are three individual single premium immediate variable annuities (Pl. Ex. 7, R. 206, 677—life annuity with no refund at death; Pl. Ex. 8, R. 207, 681—joint and last survivor annuity with no refund at death of last survivor; Pl. Ex. 9, R. 208, 685—life annuity, ten years guaranteed); three group policies (Pl. Ex. 10, R. 208, 689—pension trust; Pl. Ex. 11, R. 209, 701—group deposit administration; Pl. Ex. 12,

R. 210, 713—group, money or unit purchase);[3] and a "family protection" policy (D. Ex. 29, R. 840). For reasons never explained NASD/SEC focus their attack on the individual deferred annuity policy.

Life insurance companies, through their various types and forms of life annuity contracts, perform the basic insurance function of combining a large number of exposure units (annuitants) so that a group aggregate of assets may be liquidated over the uncertain life spans of the group (NASD/SEC expert, R. 220). The risk involved in longevity: the danger of outliving one's earning power and one's savings. Though the insurer cannot foresee how long any one annuitant will live, mortality tables and actuarial science provide the basis for estimating the average lifetimes of groups (NASD/SEC expert, R. 254-257; see also 456-459).

Each annuitant in effect agrees that if the insurer (by assuming and distributing the mortality risk) will guarantee payments through his life ("the status for which the contract provides": NASD/SEC expert, R. 194), then he will accept forfeiture in the event of his early death so that his unused reserve[4] may inure to the benefit of the group. As an NASD/SEC expert explained (R. 255), VALIC guarantees mortality. A company guaranteeing mortality must "have some mortality profits on early deaths to offset the loss on deaths later on" (R. 255).

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[3] The major portion of the life insurance annuity business today is in the group annuity field. (NASD/SEC expert, R. 257)

[4] The valuation of VALIC's reserves has been examined and certified by the District Insurance Superintendent (D.Ex. 1, R. 270, 812). The adequacy of VALIC's reserve was not disputed by the NASD/SEC actuarial expert (R. 275).

Variable and fixed-dollar life annuities are identical from the standpoint of insurance principles (R. 470). The life insurance companies apply to each the same specialized actuarial knowledge and techniques (R. 487). This actuarial science, uniquely an aspect of the insurance business (NASD/SEC expert, R. 126-127), forms part of the fundamental know-how of state insurance authorities, whose duty it is to determine the fairness and soundness of all life insurance contracts. It is wholly foreign to the security business or to security regulation (NASD/SEC expert, R. 215).

Only one unfamiliar with life insurance could assert (NASD Pet. p. 5, without supporting record citation) that "there is no life contingency involved in the pay-in period." VALIC's deferred life annuity contract, issued today, guarantees that at retirement, often decades hence, annuity payments starting at a specified dollar amount and varying thereafter only to the extent that VALIC's net investment results vary from an assumed 3½%, will continue throughout the life of the annuitant (F.F. 30, 33-A-i, R. 100, 102; NASD/SEC expert, R. 255). *VALIC assumes this mortality risk the day it issues the contract* (R. 461, 463-65; NASD/SEC expert, R. 221, 248-250).

The nature of this insurance risk is evident from the numerous mortality tables which insurance actuaries have developed over the past 70 years to provide for improving mortality (NASD/SEC expert, R. 250). Annuity contracts still in force, issued 50 or more years ago and based on then current mortality tables, today commit American insurance companies to payments substantially in excess of those now

offered in the light of present-day knowledge of mortality experience.

In the administration of its insurance obligations, VALIC employs statistical devices referred to as "accumulation units" and "annuity units." The trial court found: "The 'accumulation unit' is a symbol designed and used for the purpose of keeping the policyholder informed as to the cash surrender value of his policy and the investment experience of the company. . . . *VALIC has no account reflecting 'accumulation units'. 'Accumulation units' have no function in the actuarial operations of the company*" (F.F. 36, R. 105, emphasis added). The trial court also found: "The 'annuity unit' is a symbol designed and used to keep the annuitant or beneficiary informed as to the measure of his annuity payment, and the investment experience of the company . . . *'Annuity units' do not appear on the books of account of VALIC*" (F.F. 37, R. 105, emphasis added). VALIC, like all life insurance companies, keeps its books of account on a cash basis (R. 524, 549), and the statistical symbols are mere mechanical details of the insurance operations of the company, and are so treated in the opinion of the Court of Appeals.

Petitioners argue that VALIC has an "investment fund" (NASD Pet. 4); and that the policyholder has a "share" or "interest" therein (SEC Pet. 4-5).[5] The reserves of VALIC are not a "fund", since each reserve represents a *liability* determined by actuarial calculations (R. 549, 555). That such reserves are liabilities, not assets, (R. 564) is agreed upon by all

[5] SEC abandoned Count Three of the Complaint (R. 6) which alleged that VALIC was a depositor and underwriter of a "Fund".

insurance authorities (NASD/SEC expert, R. 117).[6] When VALIC issues life insurance and annuity policies, it collects premiums. From these premium receipts VALIC makes investments (including the purchase of equities) for its own account. Such investments are VALIC's assets, owned and held by it to meet it liabilities under outstanding policies (R. 549).

The investment securities acquired by VALIC do not pass, by sale or exchange or otherwise, to any "fund," to any annuitant or to anyone else. (R. 515-16, 549) Neither does an annuitant or anyone else have an aliquot share in the investment securities. VALIC's policyholders, like those of any insurance company, *are general creditors* who look to all the company's assets for performance of its contractual obligations. That is the sum of their "interest" in VALIC's assets.[7]

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[6] "A liability exists wherever a company is 'liable' (bound or obligated) to pay out assets now or in the future. *Thus the policy reserves of a company are not assets but liabilities* . . . Because the reserve creates a need for assets, it is common to refer to the reserve as 'a fund.' For the purposes of a non-technical discussion, the misnomer is of little consequence; in fact, it is often difficult and awkward to avoid such reference. However, *the reserve is not a 'fund' because it is a liability,* and a liability is an accounting measure of obligations." (p. 556) Mehr & Osler Modern Life Insurance, 553-556 (1956). See also Maclean, Life Insurance (17-18) (1957).

[7] All VALIC's assets stand behind its obligations and guarantees (SEC expert, R. 282, 296). VALIC's assets as of March 1, 1957, were nearly $640,000 (P. Ex. 4, R. 648). This is over eight times the total annual premium payable on all annuity policies in force ($74,824.51, R. 540).

REASONS FOR DENYING THE WRITS

I

The Court of Appeals held that the McCarran-Ferguson Act, the Securities Act of 1933 and the Investment Company Act of 1940 "show an *unmistakable* determination on the part of Congress to leave the insurance business *in the control of the States* until Congress should in plain terms exert its power over some or all aspects of it."

This Court, in *Federal Trade Commission* v. *National Casualty Co., et al* — U.S. —, 78 S. Ct. 1260 (June 30, 1958), held: "An examination of [the McCarran-Ferguson Act] . . . and its legislative history establishes that the Act withdrew from the Federal Trade Commission the authority to regulate respondents' [insurance companies'] advertising practices in those States which are regulating those practices under their own laws."

The decision of the Court of Appeals thus falls squarely within the holding of this Court in *Federal Trade Commission* v. *National Casualty Co.* Faced with this inescapable bar to their petition, NASD/SEC seek to summarily dispose of the *National Casualty* decision with footnote comments that it is "inapposite" (NASD Pet. p. 10), or that it "has no present bearing" (SEC Pet. p. 15). In truth, no decision could be more "apposite," or have a more decisive bearing.

The present action is an *a fortiori* situation. NASD/SEC do not deny that VALIC is a *life insurance company,* or that the *insurance* commis-

sioners have exercised, and are exercising their regulatory powers with respect to its operations. The District and state insurance officials have authorized VALIC's incorporation and operation, received its security deposit, approved its variable life annuity policies, examined its accounts, valued and certified its policy reserves, received its annual reports and licensed its agents—all under controlling *insurance* statutes.

The most casual examination of the 253 sections of Title 35 of the District of Columbia Code will dispel any spurious anxiety which NASD/SEC may profess for VALIC's policyholders:[8] The District Insurance Superintendent has "supervision of all matters pertaining to insurance companies, subject only to the general supervison of the Commissioners" (§ 35-101 D. C. Code). The reports on file with him are public. Every detail of the organization of a company, the policies it issues, the operations of its home office, the sales activities of its agents, is fully regulated, not merely as to "full disclosure", but also to assure continuing fairness to policyholders. The disclosure of the most intimate basic financial data is assured, rigid sanctions are provided against false or misleading statements or advertising, and protection is afforded against impairment of capital.

VALIC may invest only in securities legal for investment by other life insurance companies incor-

[8] Public Law 85-334, approved February 22, 1958, made significant changes in the insurance laws of the District. It gave the Insurance Superintendent even greater regulatory powers. Since the Act was passed after the decision of the District Court, it becomes obvious that neither the Congress nor the Insurance Superintendent felt that it was necessary to have any enabling or specific, implementing legislation relative to the variable annuity.

porated in the District (L.I.A. § 35-535). Argument by petitioners that VALIC's investments are not adequately restricted amounts to a contention that Congress has not properly safeguarded the public in establishing its statutory standards for investments for life insurance companies, and in creating the Insurance Department to see that these statutes are observed.[9] No basis is asserted in any of the briefs below or in the petitions for certiorari for superseding this decision of Congress, and the implementation thereof through the District Insurance Superintendent.

In this connection it is pertinent to note both NASD/SEC have gone outside the record with respect to the purported views of the National Association of Insurance Commissioners and the National Association of Securities Administrators (NASD Pet. p. 9; SEC Pet. pp. 15-16). There is no uncertainty, however, in the views expressed by these Insurance Commissioners, the best-informed public officials in the insurance field:

> "4. supervision over the company including the issuance and sale of variable annuity contracts *should come under the jurisdiction of the state insurance department;*" (NASD Pet. Appendix C, p. 45)

Do Petitioners advance any reason which would lead this Court to retrace the ground so recently

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[9] The Investment Act of 1940 itself uses as its standard for face-amount certificate companies thereunder, and defines as "qualified investments" therefor, those investments "of a kind which life-insurance companies are permitted to invest in or hold under the provisions of the Code of the District of Columbia . . . Such investments shall be valued in accordance with the provisions of said Code where such provisions are applicable." § 28(b)

examined in the *National Casualty* case? VALIC will comment briefly on the four theories urged.

II

First, NASD (Pet. 10) and SEC (Pet. 7) argue that the Court of Appeals erred in rejecting the NASD/SEC claim that VALIC's variable life annuity policies are "securities" within the definition in the Securities Act of 1933.

The inherent nature of life insurance and life annuity contracts issued by insurance companies under the supervision of insurance administrators differentiates them from securities required to be registered under the Act of 1933. H.R. Rep. No. 85, 73rd Cong., 1st Sess., p. 15 (1933), made this clear. There the Committee explained that § 3(a)(8) in that Act, exempting insurance policies, was inserted to make clear

> ". . . what is already implied in the Act, that insurance policies are not to be regarded as securities subject to the provisions of the Act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the Act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the Act, but the specific exemption is included to make misinterpretation impossible."

That a life annuity is not a "security" was settled in *Haberman* v. *Equitable Life Assurance Soc'y*, 224 F.2d 401, 225 F.2d 837 (5th Cir. 1955), certiorari denied 350 U.S. 948 (1956). The Texas Securities Act, on which that case turned, defined "security" in

terms identical to those of the Securities Act of 1933, but did *not* exempt "insurance . . . policy or annuity contract." The opinion in *Haberman* matched the inherent nature of the life annuity contract against the definition of "security" and concluded that a life annuity contract was not a "security."

No other result can follow objective analysis of the nature of "securities" as compared to a life annuity contract. Whether an individual security holder lives or dies has no significance to an organization issuing a security or to other holders of its securities. Each security holder receives the same payment as every other holder of the same class—and under exactly the same circumstances. Realization does not depend on any contingency of life peculiar to the holder as an individual, or his beneficiaries.

By contrast, a life annuity contract is one unit of a group activity for shifting and distributing the insurable risk of individual longevity. Save for sheer coincidence, each annuitant will receive an amount different from that of every other policyholder, an amount dominantly controlled by his age, sex and length of life. No arrangement could be further from the concept of a "security."

But, petitioners say the opinion below is in conflict with *SEC* v. *W. J. Howey Co.*, 328 U.S. 293 (1946), and *SEC* v. *C. M. Joiner Corp.*, 320 U.S. 344 (1943).

The *Howey* case sets forth the concept of a "security" under the 1933 Act as including an investment in a "common enterprise." Count One of the Complaint, on which the other Counts explicitly rest, is grounded wholly on the misconception that a variable life annuity policy is a share in a "common

enterprise." No less than eleven times the Complaint alleged in this Count the solving words "common enterprise" (R. 4-5).

Yet no Finding of Fact of the District Court, nor either of the opinions of the District Court or the Court of Appeals, even mentions "common enterprise." The term is conspicuously missing from the NASD/SEC briefs below and both petitions here.

Variable life annuities, like other insurance contracts, are the antithesis of a "common enterprise." The interest of each annuitant is inherently adverse to that of all other annuitants. The group pays and the annuitant prospers when he outlives his expectancy; the group gains and the annuitant loses when he dies early (R. 467).

Neither the trial court nor the Court of Appeals found anything in *Howey* or *Joiner* relevant to this controversy. Neither case was mentioned in either opinion. The contention that there is conflict between the holding below and the *Howey* and *Joiner* opinions of this Court is wholly without merit.

SEC gives no record reference (because none exists) to support their bald assertion that VALIC's policyholders bought or looked to the policy as a profit making venture.[10] (SEC Pet. 8-9)

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[10] Income and estate taxes make completely unrealistic any argument that a variable annuity can be used as a "speculation." We note two illustrative facts:

Should an annuitant elect to take the cash surrender value of his policy during or at the end of the premium payment period, any resulting excess of receipt over cost would be taxed *as ordinary income, not capital gains.* I.R.C. § 72(e); U.S. Treas. Reg. § 1-72-11 (1956).

Should an annuitant die, any excess of the cash value of his

The reasons for buying an annuity differ basically from those for buying a security. In applying for a variable annuity, the motive is two-fold. Primarily the purchaser wants to insure an income guaranteed to continue for as long as he may live. Subordinately, he seeks an annuity on which payments will tend to equalize with the changing purchasing power of the dollar; or putting it another way, he seeks to protect himself from continuing loss of purchasing power *because of inflation.*

The motivation of the policyholder is clearly expressed in the opinion of the Circuit Court:

> ". . . the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last."

As variable annuities are not "securities," they do not come within the Securities Act of 1933 or the Investment Company Act of 1940. The latter Act is applicable only to an "issuer" of a "security" (§§ 2(a)(21) and 3(a)).

If variable annuities were "securities," the Investment Company Act would make their issuance impossible, despite their approval by the District Insurance

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policy over premiums paid, realized at death, will be taxed both as ordinary income and as a part of his estate. Any survivor annuity is included in the gross estate at replacement cost including "loading." I.R.C. § 2039(a); U.S. Treas. Reg. 105, § 81.10(i)(1). Proceeds payable to a beneficiary, or to the estate are included in the gross estate. I.R.C. § 2039(a). But the survivor, beneficiary or estate does not receive a stepped up basis for later taxation (I.R.C. § 1014(b)(9)(A)).

Superintendent, since Section 18(f) makes it unlawful for an open-end investment company to have any class of security with a claim on its assets senior to that of its stockholders, and Section 18(a)(1)(A) makes it unlawful for a closed-end investment company to issue an obligation having such a senior claim unless it has an asset coverage of 300%. Both, of course, would *bar* the policies approved by the District Insurance Superintendent. This would not result in SEC regulation but in the *utter destruction* of VALIC.

The Investment Company Act of 1940 is, of course, expressly not applicable to an "insurance company." § 3(c)(3)

III

Secondly, petitioners argue (NASD Pet. 11; SEC Pet. 10) that the Court of Appeals erred in rejecting the NASD/SEC claim that VALIC's variable life annuity policies are not exempt under § 3(a)(8) of the 1933 Act. Two arguments are advanced, both rejected below:

(a) Petitioners say that an insurance contract is not an "annuity" unless it fixes in advance stated and unalterable dollar amounts for all annuity payments. The sole case authority[11] relied upon is an 1856 opinion by a New York surrogate (*Booth* v. *Ammerman,* 4 Brad. Surr. 129), which determined the date upon which interest would begin to run on a legacy of "the interest upon $1500" to be paid to a lady during

[11] NASD also cites in a footnote (Pet. p. 12) a trade journal article. This Court is respectfully referred to the scholarly article by Day, "A Variable Annuity Is *Not* a Security," 32 Notre Dame Lawyer 643 (1957).

the uncertain period, not of her life, but of her widowhood. A case more "inapposite" to the present issues could hardly be selected.

There is no contention by petitioners that any provision in the Life Insurance Act requires that life annuities be payable in a fixed and frozen number of dollars. The ruling to the contrary by the District Corporation Counsel and the District Insurance Superintendent stands unchallenged.

The argument that fixed and frozen dollar payments are essential to the insurance concept was specifically rejected, under analogous New York statutes, in *In re Supreme or Cosmopolitan Council of Brotherhood of Commonwealth,* 193 Misc. 996, 86 N.Y.S. 2d 127 (Sup. Ct. 1949).

The argument that fixed and frozen payments are essential to annuities likewise runs counter to Federal Income Tax Regulation § 1.72(b)(3), providing the same tax treatment as for fixed annuities for annuities in which "the amount of the periodic payments may vary with investment experience."

In enacting the Securities Act of 1933, Congress intended to extend federal regulation to an otherwise inadequately supervised field: the sale of securities. In excluding from the Securities Act the contracts issued by insurance companies, Congress did not rely on verbal definitions inviting semantic battles. It chose a pragmatic, concrete test which was not susceptible of mistake: the insurance or annuity contract was to be one issued by a company supervised by state or District insurance authorities. Obviously, VALIC satisfies this test.

Aside from statutory clauses required in certain policies (e.g. cash surrender value, and non-forfeiture provisions), there are no standard forms of insurance policies, and insurers design and seek approval of policies offering improved forms of insurance service as new needs, or new solutions for old needs, are discerned (NASD/SEC expert, R. 227).

> "It has been estimated that more than half of all life insurance in force today represents uses of insurance protection which have either been introduced or received their major development in the past 25 years. Included are the family income plans . . . retirement income insurance . . ." etc. (1956 LIFE INSURANCE FACT BOOK, being Ct. Ex. 1, not printed, p. 12)

Congress recognized and relied upon the "expertise" existing in the insurance departments of the states and the District. Congress made clear that it did not intend to subject the insurance industry and its policyholders to the confusion and the expense which would be inevitable if it launched a Federal agency, such as SEC or FTC into insurance regulation.

There is not the slightest support, either in the language or the legislative history of the 1933 Act for the contention that Congress intended by that statute to freeze insurance coverage within the forms that had been employed prior to its enactment.

Recently the government argued in this Court that health insurance "should be limited to the particular forms of insurance conventionally made available". This Court rejected that contention in the absence of support therefor in the legislative history or the definitions of the Act involved. *Haynes* v. *U. S.*, 353 U.S. 82 (1957).

(b) NASD, as a second subpoint under its claim that VALIC's policies are not life insurance annuities, asserts (Pet. p. 13) that the opinion below conflicts with *Helvering* v. *LeGierse,* 312 U.S. 531 (1941).

The *LeGierse* case and *Keller* v. *Commissioner of Internal Revenue,* 312 U.S. 543 (1941), were tax cases concerned with an arrangement whereby an insurance company simultaneously sold to a purchaser (i) a life insurance policy and (ii) an immediate life annuity. Actuarially, the premiums were so calculated that the ostensible mortality risks cancelled out. For the long-lived, annuity payments were offset by deferral of payment of life insurance. Early death matured the life insurance payment but cancelled the annuity obligation. This Court held that the funds derived from such an arrangement were not received as "insurance" under the tax laws. As stated in *Helvering* v. *Tyler,* 111 F.2d 422, 426 (8th Cir. 1940), "the *company assumed no pecuniary risk in respect of the duration of Mr. Tyler's life.*"

This pecuniary risk incident to the duration of life is precisely the risk which VALIC and any other life insurance company *does* assume. Clearly there is no conflict between the decisions of lower courts and *LeGierse* or *Keller.*

IV

Thirdly, NASD asserts (p. 14) and SEC implies (p. 16-17) that this Court should grant the writ on the theory that the holding of the Court of Appeals conflicts with the decision of the Supreme Court of Errors for the State of Connecticut in *Spellacy* v. *American Life Insurance Co.,* 144 Conn. 346, 131 A.2d

834 (1957). This makeweight argument is so superficial it hardly merits notice.

In *Spellacy,* the Connecticut court, on the petition of the state *Insurance Commissioner,* merely held that under the Connecticut *insurance statutes* a fraternal benefit society was not authorized to issue a proposed form of endowment contract. Accordingly, this contract was never sold by the company. The SEC Petition, p. 17, which purports to describe the contract as one being currently offered simply misstates the facts. The Connecticut Court did not hold that the proposed policy was a "security" and its reference to variable annuities was pure dictum, not within any of the questions reserved for the decision of the appellate court.

To assert that this Court should review the considered decision of the Court of Appeals because of a gratuitous dictum in an unrelated Connecticut decision dealing with different statutes and different facts evidences something little short of desperation.

SEC also relies upon *Coastal States Life Insurance Company* v. *Kelly,* Court of Common Pleas, Richmond County, So. Car.; and argues that in that case the court passed "upon a contract substantially identical to the variable annuity." (Pet. 16).

The contract involved in that litigation had *no* features either resembling or relating to the variable annuity. *Coastal States,* a Georgia company, offered in South Carolina a policy which included provisions labeled "Estate Builder Contract". These provided "interim endowments" of $100 a year for 18 years (the first a double amount, $200, after 2 years). The sole issue was the applicability to such provisions of So. Car. Code (1952) § 37-145, prohibiting an *insur-*

ance company from issuing any contract offering an "inducement to the taking of insurance." The *Insurance Superintendent* of South Carolina prohibited issuance of the policy on the ground that the estate provision constituted such an "inducement" and the Court sustained him.

In neither the *Spellacy* case nor the *Coastal States* case was there an attempt to enforce a "securities" law. Each determined whether a particular contract was permissible under the insurance laws of the state involved. Each upheld the local insurance commissioner and clearly illustrates the effectiveness of *state* insurance regulations. Neither gives any support to the theory that SEC should supersede state insurance authority.

V

Finally, Petitioners assert that this Court should review the decision below because "it introduces a novel and legally unwarranted test under the Securities Act which is administratively impractical" (NASD Pet. p. 15); or as somewhat differently stated by SEC "will hamper effective enforcement" of the securities statutes (Pet. p. 13); or "oust" SEC "of currently exercised jurisdiction" (Pet. p. 18).

Even if it were proper—which it is not—to decide this case on concepts of "administrative practicability" rather than on the pertinent statutory and decisional authority, the judgments below are manifestly correct.

Nothing could be more "administratively impractical" than having the SEC "second-guess" the forty-eight state insurance administrators with respect to

the operations of the 1,144 United States life insurance companies.[12]

New policy forms are under constant development as the industry has adapted its product to changing public needs (R. 411).[13] When an insurance commissioner in the daily conduct of his duties is called upon to determine whether he will approve a proposed new policy form, is he first to send it to the SEC for information as to whether the SEC thinks the policy is a "security"? Nothing could create greater administrative confusion. The insurance commissioner's function is to determine whether a proposed policy offers a lawful and otherwise appropriate insurance coverage under the state law he administers. If so, he approves it; if not, he disapproves it. On occasion, as in the *Spellacy* case, he may seek judicial guidance as to the interpretation of the *insurance* laws of his State.

But nothing in the federal system, especially in the light of the McCarran-Ferguson Act, suggests that the

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[12] As of June 30, 1956, there were 1,144 life insurance companies organized in the United States. 1957, LIFE INSURANCE FACT BOOK, p. 48.

[13] For example the family plan policy, first introduced in August, 1956, accounted for 20% of all ordinary life insurance bought in 1957.

"Purchases of life insurance by American families in 1957 reached a record $66.7 billion . . ., $11.4 billion or 21% more than in 1956.

• • • •

"Some of the 1957 increase in the average size ordinary policy purchased came from the large volume of *family plan* insurance sold in the year . . . In 1957, there were *800,000* family plan insurance policies purchased to cover *3.2 million persons* for a total of $8.5 billion of protection. The family plan purchases totaled nearly 20% of all ordinary life insurance bought in 1957." Life Insurance Fact Book (1958) pp. 19-21.

state insurance commissioners, *who are regulating in fact,* are to be made subordinates of SEC, or any other Federal agency, exercising their administrative functions at its sufferance. Congress, which enacted both the District Code (including the L.I.A.) and the Securities Acts, carefully included the District of Columbia within the definition of a "State" in the McCarran-Ferguson Act and expressly provided therein that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of *regulating* the business of insurance . . ., *unless* such Act *specifically* relates to the business of insurance." (§ 1012(b)). Hence, it is clear that Congress did not intend that the District Insurance Superintendent and SEC should regulate the same activity.

In arguing that the decision below will "hamper effective enforcement" by it of the securities acts, SEC relies on the provisions therein that there "may be concurrent regulation by the Securities Exchange Commission and state commissions" (SEC Pet. p. 13). This argument is specious. The "state commissions" with which SEC is to have concurrent jurisdiction are the state *securities* commissions. Securities Act, 15 U.S.C. § 77r; Investment Company Act, 15 U.S.C. §80a-49). The express language of the McCarran-Ferguson Act, as well as its clear intent, shows, as the Circuit Court said, "an unmistakable determination on the part of Congress to *leave* the insurance business in the control of the States until Congress should in plain terms exert its power over some or all aspects of it."

NASD (Pet. p. 15) inquires what the variable annuity policy is "in a state such as Connecticut, which says it is not" insurance. The answer, of course, is simple

and self-evident. Under the Connecticut statutes as now worded, if they ultimately are construed in harmony with the dictum in the *Spellacy* case, a life insurance company will not be authorized by the Connecticut Insurance Commissioner to sell variable annuity policies without legislative sanction. Since only a life insurance company can sell these contracts, a resident of Connecticut will not be able to buy a variable life annuity from a company operating in that state.

The choices are not, as NASD (Pet. p. 15) suggests, between "insurance," "investment contract" (i.e. "security"), and "a scheme beyond control." The variable life annuity contract unquestionably is insurance; the choice of the state is merely whether under its own applicable insurance statutes life insurance companies authorized to transact business within its boundaries may properly be authorized to offer this type of retirement protection to the public.

This state-by-state development of the insurance industry was precisely what Congress envisaged in passing the McCarran-Ferguson Act. As this Court stated in *Prudential Insurance Co.* v. *Benjamin*, 328 U.S. 408 at 429-30 (1946), in enacting the McCarran-Ferguson Act:

> "... Congress must have had full knowledge of the nation-wide existence of state systems of regulation and taxation; *of the fact that they differ greatly in the scope and character of the regulations imposed* and of the taxes enacted ... Congress could not have been unacquainted with these facts and its purpose was evidently to throw the whole weight of its power behind the state systems, *notwithstanding these variations.*"

The decisions below effectuated this Congressional intent. Since only life insurance companies, under state insurance supervision, can offer variable life annuity contracts, a fact conceded by everyone, it is a conspicuously idle gesture which NASD here solicits from this Court: an advisory opinion as to what a variable life annuity contract "is" in a state where under the current interpretation of the current insurance statutes such an insurance contract is not sold.

The suggestion (SEC Pet. p. 18) that it would be a simple matter for persons managing mutual fund investment companies to add a periodic accumulation plan with an " 'annuity' " provision is, of course, consistent with the studied effort of SEC throughout this litigation to ignore the existence and scope of insurance laws and regulations. If this were such a simple matter, obviously NASD, the trade association of the investment industry, would not be here in an effort to destroy through litigation this little insurance company.

All mutual fund investment companies are formed under the *general* corporation laws of a state which expressly exclude insurance companies. Accordingly, all life insurance companies are formed under the *insurance* laws of a state. No mutual fund investment company could amend its charter under the applicable general corporation laws so as to authorize the variable annuity. This is clearly illustrated by the recent action of Investors Diversified Services, a mutual fund investment company which formed Investors Syndicate Life Insurance and Annuity Co., a wholly owned subsidiary, to write the variable annuity. In such case, SEC continues to regulate the mutual fund investment com-

pany, and the insurance commissioner will regulate the life insurance company. Hence, there is no conflict; neither is SEC ousted of jurisdiction.

The decisions below are not in conflict with the decision of any court, State or Federal.

CONCLUSION

For the foregoing reasons, the Petitions for Writs of Certiorari should be denied.

Respectfully submitted,

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APPENDIX I

The McCarran-Ferguson Insurance Regulation Act (Act of March 9, 1945; c. 20; 59 Stat. 33, as amended; U.S.C. Title 15, § 1011-1015):

§ 1011.

Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

§ 1012.

(a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

§ 1013.

(a) Until June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, and the Act of June 19, 1936,

known as the Robinson-Patman Anti-discrimination Act, shall not apply to the business of insurance or to acts in the conduct thereof.

(b) Nothing contained in this chapter shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.

§ 1014.

Nothing contained in this chapter shall be construed to affect in any manner the application to the Business of insurance of the Act of July 5, 1935, as amended, known as the National Labor Relations Act, or the Act of June 25, 1938, as amended, known as the Fair Labor Standards Act of 1938, or the Act of June 5, 1920, known as the Merchant Marine Act, 1920.

§ 1015.

As used in this chapter, the term "State" includes the several States, Alaska, Hawaii, Puerto Rico, Guam, and the District of Columbia.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

Nos. 237 and 290

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., and SECURITIES AND EXCHANGE COMMISSION, *Petitioners,*

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, and THE EQUITY ANNUITY LIFE INSURANCE COMPANY, *Respondents.*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

BRIEF FOR THE EQUITY ANNUITY LIFE INSURANCE COMPANY, RESPONDENT

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---

BRIEF FOR RESPONDENT THE EQUITY ANNUITY LIFE INSURANCE COMPANY

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 257 F. (2d) 201, (R. 885-891). The opinion of the District Court (R. 82-94) is reported at 155 F. Supp. 521.

JURISDICTION

The jurisdiction of this Court has been invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Did the Court of Appeals properly interpret the statutes herein involved and the legislative intent underlying them in holding that, there is "an unmistakable determination on the part of Congress to leave the insurance business in the control of the states until Congress should in plain terms exert its power over some or all aspects of it . . ." and "the definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of the state subjects the business to his supervision, it is the business of insurance"?

STATUTES INVOLVED

The statutes involved are set forth in Appendix A to the brief of the Securities and Exchange Commission with the exception of the District of Columbia Life Insurance Act of 1934, Title 35, Chapters 3-8 of the District of Columbia Code (1951 Ed.). It is not practicable to set out such an extensive Act in this brief.

STATEMENT OF THE CASE

As stated by Petitioner, National Association of Securities Dealers, Inc. (hereinafter "NASD"), individual variable annuity contracts were first written in the United States in 1952. (NASD Br., p. 5). Group variable annuity contracts were written by the major life insurance companies prior to that time. (R. 539).

Individual variable annuity contracts were first written by the College Retirement Equities Fund (CREF), chartered by the New York legislature as a companion corporation to Teachers Insurance & Annuities Association, a legal reserve life insurance company (TIAA). (R. 482-484). Since TIAA's experience had shown fixed-dollar annuities to be unsatisfactory in providing annuities for college and university teachers, it was decided to organize CREF which would invest completely in equities, but which would guarantee payments, not in terms of dollars but in terms of units. (R. 480-485). In order to avoid the investment limitations of New York law pertaining to insurance companies, CREF was created by a special Act of the legislature with supervision of the Company in the Superintendent of Insurance. (R. 484, 491). At the end of 1956, CREF variable annuities covered 31,156 individuals (D. Ex. 36, R. 847) and its net assets were $39,817,151.

CREF makes no guarantees whatsoever. It is "the best example of a pure insurance arrangement that you could have". Whatever occurs with regard to investment experience, mortality, or expenses is reflected in the payments to annuitants. (R. 485). No attempt has ever been made to require CREF to register its variable annuity policies as securities under the Securities Act or to classify it as an investment company under the Investment Company Act of 1940.

Respondents were organized and operate solely as life insurance companies under the provisions of the District of Columbia Life Insurance Act of 1934.

They are subject to the supervision of the Superintendent of Insurance of the District of Columbia and the Insurance Commissioners of other states in which they are licensed to do business. (F.F. 3-23; R. 94-99). The only business which the respondents are permitted to conduct "shall be restricted to the business of insurance appertaining to persons." Title 35, § 501(d), D. C. Code. (F.F. 4; R. 95). Respondents operate on a general agency basis. Every general agent and every agent selling respondents' policies must be licensed by the Insurance Department in either the District of Columbia or the state in which the company operates. (F.F. 25; R. 99). All of the details of respondents' organizations have been approved by the Superintendent of Insurance and the Corporation Counsel of the District of Columbia. (F.F. 5-15, R. 95-98). All of respondents' policies have been approved by the Superintendent of Insurance of the District of Columbia as required by § 35-708 of the D. C. Code, and by all states in which the companies are licensed. (F.F. 31, R. 101; F.F. 23, R. 99; R. 506). These policies and their general terms and provisions are described in Findings of Fact 31-35, R. 101-105. Such policies contain the standard provisions required for annuities as set forth in § 35-705, D. C. Code. The legal investments for respondents' funds, as for any other life insurance company chartered in the District of Columbia, are set forth in § 35-535 of the D. C. Code. (F.F. 39, R. 106). Respondents' Articles of Incorporation, approved by the Corporation Counsel of the District of Columbia, permit them "To grant, purchase or dispose of life insurance and variable annuity policies stated in terms of units, the value of which is based

in whole or in part on equity type of investments permitted by Section 535 of said 'Life Insurance Act' of the District of Columbia, as amended, and as the same may hereafter be amended." (F.F. 4, R. 95; F.F. 18, R. 98).

Respondents issue a number of variable annuities in addition to the individual deferred annuity policies on which petitioners rest their case. (SEC Br., pp. 3-4; NASD Br., p. 5). All types of respondents' variable annuity policies have the same "pertinent characteristics" as SEC asserts. Br. pp. 3-4. One example of such other policies may be illustrative.

In 1957 this respondent issued a $30,000 single premium immediate variable annuity policy to one Grenville Clark, aged 74. Such policy guaranteed: (1) Annual payments for the life of the annuitant. (2) The first payment to be due February 1, 1958. (3) The dollar amount of each such payment will be measured by the value on payment date of 3827.50 annuity units. (4) The mathematical formula for adjusting the value of the annuity unit in accordance with investment experience. The dollar amount of the annuity payments determined in accordance with the provisions of the contract will vary with the investment experience of the company but cannot be reduced by company expenses (other than certain taxes) or by the company's adverse mortality experience, if different from that of the Progressive Annuity Mortality Table. (D. Ex. 102; R. 877-880).

The Grenville Clark annuity, like all other of respondents' contracts, has characteristics unknown in a "security": (1) his rights terminate on death, his estate receiving no payment thereafter; and his

right to a determinable annual amount, established by his sex and age, continues as long as he lives, regardless of how long this may be. Petitioners' security experts knew of no security having such characteristics. (R. 305-306, 394). (2) Clark's risk of outliving his capital is shifted to the company, which guarantees the mortality assumptions and, subject to such guarantee, distributes the risk among the group of annuitants; i.e., reserves released by early deaths become available for payment to those having extended longevity. (R. 458-459).

Respondent agrees with SEC that a security holder's "risk is identical to that of all others who purchase the same security." Br. pp. 33-34. Conversely, an annuitant's risk is inextricably personal to him since its benefits are dependent upon the continuation of his life.

An annuity is a contract between a policyholder and a life insurance company which must provide for the payment of an income to a specified person, which income continues for, and only for, the lifetime of that person, the amounts of the payments being determined in such manner as to expend both principal and interest over the lifetime of the annuitant. Such annuity payments must be determined by actuarial methods involving the use of a mortality table. (R. 457, 478). A variable annuity is an annuity. (F.F. 30, R. 100; R. 281-282, R. 415, 467-468, 486, 489). Mehr & Osler, *Modern Life Insurance,* 1956 Ed., pp. 82-86; 32 Notre Dame Lawyer 643 (1957).

The distinction between a fixed-dollar annuity and a variable annuity is found solely in the presence or absence of expressed and particular dollar guarantees

of the benefits to be conferred. (R. 469-471). Actuarily both the fixed-dollar annuity and the variable annuity are calculated by identical principles. (R. 467, 471, 486-487, 489, 526-527). A fixed-dollar annuity accumulates and guarantees cash values during the pay in period. (R. 526-527). A variable annuity guarantees a formula for accumulating and determining cash values during the pay in period. (R. 526-527). A fixed-dollar annuity pays out in terms of fixed monetary units, i.e., dollars. (R. 459). A variable annuity pays out in terms of a contractually fixed formula which may yield varying dollars. (R. 459, 470; F.F. 30, F.F. 28, R. 100-101). Both the fixed-dollar and respondents' variable annuity assume the risk of mortality from the moment a contract is issued. (R. 461, 494, 538, 562).

A mortality table is an actuarial prognostication that a certain number of annuitants will survive to specified ages. (R. 217-219, 461). Since each annuity payment is in part a return of capital as well as, in part, a reflection of investment experience, the mortality guarantee is of great benefit. (R. 254, 458, 461). If a substantial number of annuitants live beyond their predicted demise, the company issuing the contract, be it a fixed-dollar contract or a variable annuity contract, must nevertheless continue to make annuity payments on the basis of the mortality prediction guaranteed by the contract. (R. 281-282, 296, 461). This is the mortality risk assumed by respondents and other insurers from the moment a policy is written. (R. 282, 296, 461, 494).

The trend over the years has been for increased life expectancy. Consequently, mortality tables used to-

day may be inadequate to compensate the insurer for the risk assumed. (R. 250, 463-465, 562, 564-565). This has occurred in the past with the result that companies had to strengthen their reserves from surplus in the light of increasing life expectancy. (R. 251-252, 464-465).

If respondents have underestimated mortality, a portion of annuity payments must be provided from assets otherwise belonging to stockholders. (R. 282, 461, 562, 564). As petitioners' expert witness confirmed, the fact that respondents are stock companies rather than mutual companies, affords greater protection to policyholders. (R. 299).

The distinction between the fixed-dollar annuity and the variable annuity is blurred when individual participating annuities are considered. A participating policyholder in the accumulation period may leave his dividends with the company; since dividends are never guaranteed, the total cash value in the fixed-dollar annuity contract, which is used to provide the annuity benefit upon retirement, may be unknown until retirement. In the pay out period dividends paid may increase annuity payments. Unfavorable investment experience would weaken a company's surplus and, in a mutual company, cause policyholders to participate in the loss as was the case with the Pacific Mutual Insurance Company. Participating annuities have not been classed as "securities" by petitioners. (F.F. 28, R. 100; R. 222-225, 297, 452-453, 470-471, 473, 527).

Petitioners in their treatment of risk shifting have confused the fundamental distinction between "insur-

able risk" and "investment risk" in the law of insurance. (SEC Br., pp. 8, 13, 17, 35; NASD Br., pp. 17, 19, 23, 24). The insurable risk is one which, on impact, creates a loss unique to the individual policyholder, leaving other policyholders unaffected. Such a risk can be shifted to the life insurance company and by it distributed over the whole group. (R. 456, 890-891).

Investment risks are not insurable risks because they do not satisfy two essential requirements within the definition of insurable risk; namely, that the loss must be predictable by some actuarial method and that the losses to be sustained can be shared by those who are exposed to that loss. (R. 460-461). The assumption of an investment risk by an insurance company is not an indispensable element or function of insurance. (R. 459, 472). Such fact was recognized by this Court in *Helvering* v. *LeGierse,* 312 U.S. 531. The assumption of an investment risk by an insurance company is only a "by product" of quoting premiums on a level basis, i.e., premiums payable remain constant despite changes in the policyholder's age. In the initial years of the policy the premium paid is larger than necessary to compensate the insurance company for the mortality risk assumed. A conservative portion of the investment earnings to be derived from the premium becomes the guaranteed cash value of the policy. (R. 459-460, 535). Krueger and Waggoner, *The Life Insurance Policy Contract* (1953 Ed.), 194, 251; cited, 357 U.S. 58. Such guaranteed cash values often are set at a level so that investment risk is almost entirely eliminated. (R. 472-473). Insurance policies written on a natural premium basis, where a change

of age causes a change in premium, guarantee no cash value, i.e., one year term insurance. (R. 262-263).

As the Court of Appeals held (R. 890), the insurable risk assumed by respondents is the mortality risk. (R. 220, 255, 461, 494, 538).

It is undisputed that there are millions of dollars of group insurance in force today in which the insurance companies have assumed no portion of the investment risk. The Immediate Participation Guaranteed Policy (IPG) sold by major life insurance companies including Metropolitan, Equitable, John Hancock, Prudential and Connecticut General guarantees no interest assumption; the investment risk is borne entirely and directly by the policyholder. The fund is credited or debited annually in accordance with the actual net interest rate earned by the insurance company, charged annually with actual expenses, charged with variations in experience from assumed mortality and adjusted annually for capital gains and losses (R. 539, 553-554, 561). Petitioners have never contended that these contracts are securities or that insurance companies issuing them were investment companies.

Only a life insurance company can offer a variable annuity. Spreading distribution of a capital amount and the earnings therefrom over a lifetime in accordance with scientific tables of mortality is the exclusive province of life insurance. (R. 441-442, 494). Petitioner's expert witnesses from the securities field confirm this fact. (R. 305-306, 322, 346, 392-396). If the variable annuity cannot be issued by the life insurance industry it cannot be issued by any institution.

Petitioners demonstrate a misunderstanding of the essential distinction between insurance and any other economic activity in their assertion that insurance policies *may* be written by investment companies. (SEC Br., p. 61; NASD Br., p. 37, fn. 2) They refer to the activities of United Funds, Inc., a mutual fund, to support the proposition that an investment company can be an insurance company. (SEC Br., p. 31). No evidence has been adduced to support the proposition that an investment company could write life insurance. The evidence is that United Funds, Inc., does not engage, nor wish the public to believe that it engages, in the life insurance business. United Funds, through a group creditor policy issued to it by the John Hancock Life Insurance Company, enables participants in its Periodic Investment Plan to obtain decreasing term life insurance from a life insurance company. United Funds, Inc., is not, of course, regulated by any state Department of Insurance. (R. 347-357).

Similarly, SEC misstates the case in asserting that there is an investment company which has an arrangement with an insurance company whereby shares of the investment trust are converted into an annuity based on a mortality table guaranteed by the insurance company at the time of buying into the mutual fund. SEC further asserts that "these companies" are registered with SEC under the Investment Company Act. (Br., p. 32). The companies referred to, Advisers Fund, Inc., and Standard Life Insurance Company, have provided in their arrangement that Standard Life "reserves the right to withdraw the offer or modify the rates or other terms of the commitment . . .". (R. 450-451, 808). Standard Life is not regis-

tered with SEC as an "investment company" nor are its annuities registered with SEC under the Securities Act.

Mechanics of Calculation of Variable Annuity Benefits

A life insurance company issuing a deferred variable annuity or a deferred fixed-dollar annuity exchanges its contractual promises for the premium paid by the policyholder. The premiums are the property of the insurance company. A policyholder is under no obligation to continue to pay premiums. (R. 124, 221, 296 469, 544, 554). After deducting from the premiums amounts specified in the policy, the net premiums become part of the total investable assets of the company. The investable assets must be invested only as authorized by Congress for all District of Columbia life insurance companies. Title 35, § 535, D.C. Code. (F.F. 39, R. 106). Investable assets include capital and surplus as well as net premiums, there being no segregated funds. (R. 296, 550).

In a fixed-dollar annuity net premiums are accumulated and adjusted by a nominal assumed investment rate. (R. 497). In a variable annuity net premiums are accumulated and adjusted by actual investment experience. (R. 527). The parallel between the cash value accumulations on fixed-dollar and variable annuities is shown by D. Ex. 41, R. 853.

Accumulated cash value could be reported annually to variable annuity policyholders on a dollar and cents basis as the books of the company are kept. However, reporting only a dollar cash value would not enable the policyholder to ascertain what portion of the cash value would be attributable to investment earnings and what portion would be attributable to his new

premiums. Accordingly, it was decided to report cash values to policy holders in terms of accumulation units—the number of which represents net premiums applied—and the dollar value of which represents the index of the company's investment experience. (F.F. 36, R. 105; R. 527).

At the commencement of the pay out period the accumulated cash value of either a fixed-dollar or a variable annuity is used to provide the annuity benefit selected by the annuitant; if he wishes he may withdraw his accumulated cash value. (R. 221, 498). His death prior to the pay out period results in such cash value being paid to his beneficiary. (R. 235) In either type annuity, in insurance terminology the annuitant is exercising an option and his accumulated cash value is converted to purchase the benefit. (R. 123, 254, 487). Using the accumulated cash value and the mortality table guaranteed in the policy, the annuity benefit is determined and the annuitant is paid that amount for the first month. If respondents' investment experience thereafter is always precisely 3½%, all subsequent payments will be the same. To the precise extent that such investment experience varies from 3½%, the subsequent annuity payments will vary. (F.F. 37, R. 105; R. 181-182, 487, 528).

As in the accumulation period, the company uses a reporting device, the annuity unit, the value of which informs the policyholder of the variations in the company's actual investment earnings from the assumed investment rate of 3½%. (R. 528).

The use of symbolic "units" has long been common in the life insurance business. (R. 534-537). For statistical purposes group annuities usually are re-

ported "on the basis of paid-up units set up to date, with additional units of retirement income to be added each year." 1954 Life Insurance Fact Book, p. 30. Typical fixed-dollar annuities provide for ". . . units of stipulated payment" (D. Ex. 42, R. 854) and "premium-units" (D. Ex. 43, R. 855).

Accumulation and annuity units have neither actuarial nor accounting function in the operation of the annuity business conducted by respondents. (R. 524-537). They are statistical devices designed and used for the purpose of keeping the policyholder informed as to the cash surrender value of his policy and the investment experience of the company. (F.F. 36, R. 105; F.F. 37, R. 105). Beyond this usage they add nothing to an understanding of the insurance principles on which the variable annuity is based.

The prinicpal Findings of Fact on which SEC relies, appear to be Nos. 46, 47 and 70 (R. 107, 109), Br., pp. 5, 6. In submitting proposed Findings of Fact to the District Court, petitioners did not attempt to demonstrate where evidence could be found to justify such Proposed Findings. (R. 31-47). These Findings are erroneous and predicated upon the alleged existence of a "reserve fund" in which each policyholder has an "aliquot" interest, and led the District Court into the mistaken belief that respondents had "created a reserve fund for investment mainly in common stocks." (R. 90). Insurance companies, including respondents, are required by law to maintain policy reserves. The policy reserve in life insurance is a technical expression meaning the amount of money which the company must have, together with premiums and assumed investment income, in order to meet

obligations as they are actuarily calculated to mature. Such reserve is a liability. (R. 488). Krueger and Waggoner, *supra*, p. 251. SEC's theory would result in the absurdity of policyholders having interests in a liability. These Findings were disregarded by the Court of Appeals.

As this Court has held, a policy of life insurance creates the legal relationship of debtor and creditor between an insurance company and a policyholder. No trust relation results from an insurance policy. This legal relationship has been delineated in *Equitable Life Assurance Society* v. *Brown*, 213 U.S. 25, 46 (1908):

> They lay no foundation for the jurisdiction of a court of equity in such a case, unless it appears that the relation between the policy holder and the defendant is that the latter is the trustee of the former by reason of the trust relation between them resulting from the insurance policy. The complainant's contention, as above stated, that there is such a trust in the fund mentioned, has never been regarded as the law in the state of New York . . . , nor anywhere else so far has any case has been cited on the subject. * * * It has been held that the holder of a policy of insurance, even in a mutual company, was in no sense a partner of the corporation which issued the policy, and that the relation between the policy holder and the company was one of contract, measured by the terms of the policy.

SUMMARY OF ARGUMENT

1. Under the Securities Act insurance and annuities are not within the definition of a "security". The purpose of § 3(a)(8) of the Securities Act, specifically exempting "Any . . . annuity contract" from the definition of a "security" was to make misinterpretation

of this fact impossible. The tests of exemption under § 3(a)(8)—that the contract be an annuity as determined by applicable state law and that the corporation issuing it be subject to the supervision of the insurance commissioner—cannot be disputed. The major purpose of Congress in enacting the Securities Act was to supervise through disclosure the theretofore largely unregulated securities field and not to superimpose the requirements of that Act on the fully regulated field of insurance.

2. Under § 3(c)(3) of the Investment Company Act "Any . . . insurance company" is exempt from the Act. The definition of "insurance company" in that Act, § 2(a)(17), requires that the company be organized as an insurance company, that its primary and predominant business be the writing of insurance, and that the company be subject to the jurisdiction of the insurance commissioner of a state. It cannot be disputed that respondents are organized and approved to do business solely as insurance companies, that their business is restricted by the D. C. Code and their charters to the business of life insurance and variable annuities, and that they are subject to the supervision of the Superintendent of Insurance. The purpose of Congress in enacting the Investment Company Act was to regulate the theretofore largely unregulated mutual fund industry where effective state regulation was difficult if not impossible. The purpose of Congress in enacting this statute was not to make illegal the corporate structure and policy provisions of legally approved life insurance companies and their policies.

3. Under the District of Columbia Code all aspects of respondents insurance activities and insurance policies have been found to be in conformity with law.

Regulation of respondents under §§ 18(a)(1)(A) or 18(f) of the Investment Company Act would make illegal their present corporate structures and annuity policies. Such statutory construction would impair, supersede and invalidate the state law enacted for the purpose of regulating the business of insurance. Except for the statutes enumerated in the proviso of § 2(b) and § 4 of the McCarran Act, Congress intended that no other federal statute should be construed as authorizing federal regulation of the business of insurance unless such federal statute affirmatively provides for such regulation.

ARGUMENT

I

Under the Securities Act an Annuity Is Not Within the Definition of "Security". § 3(a)(8) of the Act Furthermore Specifically Exempts "Any . . . Annuity" From the Definition of a "Security". In Enacting the Securities Act It Was the Intention of Congress That "Insurance" and "Annuity" be Determined by Appropriate State Officials.

A. UNDER THE SECURITIES ACT AN ANNUITY IS NOT WITHIN THE DEFINITION OF A "SECURITY".

In enacting the Securities Act Congress undertook to regulate the interstate sales of securities through the disclosure requirements of the Securities Act. Theretofore the interstate sale of securities had not been regulated on the federal level. Congress then knew of the history, extent and meaning of insurance and annuity policies in the United States as well as the effectiveness of state regulation of insurance. With the understanding of these facts, Congress carefully drafted the statute believing, "The entire tenor of the act would lead, . . ., to the exclusion of insurance policies from the provisions of the

act . . .". H. Rept. 85, 73rd Cong. (1933). Eminent commentators in the field of federal securities regulation concur in this view. McCormick, *Understanding The Securities Act and the SEC,* p. 79; Loss, *Securities Regulation,* p. 322, states that "it is hardly conveivable that Congress would have subjected insurance policies to fedreal control *sub silentio,* even where the control was merely of the disclosure variety."

A case in support of this proposition is *Haberman* v. *Equitable Life Assurance Society,* 224 F. (2d) 401, modified, 225 F. (2d) 837, cert. den., 350 U.S. 948. In that case, the Court considered the Texas Securities Act which does not contain a specific exemption for insurance and annuity policies from the definition of "security". The Texas definition of "security" is modeled after the definition of "security" in § 2 of the federal Securities Act. The Court concluded that the legislative history of the federal Securities Act made it obvious that an annuity was not a "security". In discussing the nature of an annuity the Court said, at pp. 405-406:

> * * * *Certainly annuities issued by regulated insurance companies are not at all similar to the securities specifically enumerated in the statute. In fact, we would not regard "investment contract" as a correct description of an annuity.* While annuities are sometimes called investments, that is not an apt characterization. Indeed, it is not unusual to hear a person say he is investing in a new suit or a new car, but the essence of such transaction is really quite different. *An annuity* is also quite *different*; what makes it essentially an annuity is *that it is a form of risk-sharing.* In life insurance, the risk from which protection is usually sought is that the insured may die young without provision for his dependents; in

an annuity, the risk is that the annuitant may live long, outliving his means for his own support. *To the extent that insurance or annuities are risk-sharing, they are certainly not investments. It is true that investment or other objectives can be combined in such plans, but they are not of their essence. Besides, we perceive a striking difference between the instruments specifically included in the definition, on the one hand, and insurance and annuity policies of regulated companies, on the other*; the latter are governed by a special statutory scheme, and reserves are required by law to be maintained for them. Thus we think the general words "investment contract" cannot be reasonably interpreted as including something so dissimilar to the specifically named instruments, as the annuity in this case. Whether they might include an annuity issued by one not a regulated insurance company, we need not decide.

As for the words, "any other instrument commonly known as a security," we do not recall a single instance in which we have heard an annuity called a security either by the learned or the vulgar. (Emphasis supplied)

However, the specific exemption for insurance and annuity policies contained in § 3(a)(8) of the Securities Act, in the words of Loss, "creates a negative implication that insurance policies *are* securities, which may be exempt from the registration requirements but are subject to the anti-fraud provisions. Nevertheless, the Commission has taken the position that insurance or endowment policies or annuity contracts issued by regularly constituted insurance compaines were not intended to be securities, and that in effect Section 3(a)(8) is supererogation." Id., pp. 322-323. As McCormick states, "only those insurance or annuity policies are exempt which are issued by

corporations under the jurisdiction of a designated insurance supervisor of a State, Territory, or the District of Columbia." Id., pp. 79-80.

Respondent concurs in the conclusions of the Court of Appeals (R. 891), the commentators, and the long settled position of the SEC, previous to this litigation, that the Securities Act did not intend to include insurance and annuity policies within the definition of "security", and that Congress did not intend SEC to inquire into the particular mechanics of any insurance or annuity policy issued by an insurance company subject to the supervision of a designated insurance supervisor.

The authority to dissect an insurance or annuity policy which SEC argues for, would, as here, create anomalies. For example, SEC here separates the deferred variable annuity into two portions, for purposes of establishing jurisdiction, and concedes that perhaps the reach of the Securities Act does not extend to the pay out period of the variable annuity. (Br., p. 43). SEC's plea for jurisdiction over the accumulation period would have no effect on respondents' immediate annuities, since they are in the pay out period immediately upon issuance, even though the immediate annuity has the same "pertinent characteristics" as the deferred annuity. (SEC Br. p. 3). Nevertheless, respondents would be classed by SEC as investment companies when a deferred variable annuity was written but would be classed as insurance companies when an immediate variable annuity was written.

If the essential legal principle involved in this case is the right of SEC to regulate annuity contracts

wherein the investment risk is borne by the policyholder, then there is no logical distinction between SEC regulation during the pay in period and SEC regulation in the pay out period. Who bears the investment risk inherent in the variable annuity is not relevant in deciding whether a state was correct in determining that a particular policy is insurance and may be issued by an insurance company.

Respondents' variable annuities are not the only variable annuities wherein the investment risk is borne by the policyholder. Under the CREF variable annuity covering more than 31,000 lives, and the IPG annuity, sold by major insurance companies in the United States, no portion of the investment risk is borne by the insurance company. SEC has not sought to regulate those policies as securities or the companies as investment companies.

The conclusion must follow from the facts that the bearing of the investment risk by an annuity policyholder is not a proper test upon which to predicate SEC regulatory authority over annuity policies and life insurance companies.

The determination of what constitutes "insurance" or "annuity" was left by Congress to the various state legislatures and appropriate state insurance regulatory officials as is shown by the legislative history of the Securities Act.

B. TO MAKE MISINTERPRETATION IMPOSSIBLE, CONGRESS PROVIDED THE SPECIFIC EXEMPTION FOR INSURANCE AND ANNUITY POLICIES

§ 3(a)(8) of the Securities Act exempts from the definition of "security", as set forth in § 2 of the Act,

> (8) *Any* insurance or endowment policy or *annuity contract* or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia. (Emphasis supplied).

It was known by Congress in 1933 that the various states had their own insurance statutes and regulatory bodies. It was also well known that the insurance industry had not been offering a static and unchanging product to the public. More than half of all life insurance in force today represents uses of insurance protection which have either been introduced or received their major development in the past 25 years. Life Insurance Fact Book, 1956. There is no evidence that Congress wanted to freeze the insurance industry into the then existing patterns of policies and coverage. The evidence is that Congress did not intend SEC to have any regulatory jurisdiction over insurance policies and companies, regardless of changes that might occur.

The House Report, accompanying the bill that became the Securities Act expresses the Congressional intent; that § 3(a)(8) was inserted in the bill to make clear

> ". . . what is already implied in the act, namely, that *insurance policies are not to be re-*

> *garded as securities* subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, *but the specific exemption is included to make misinterpretation impossible.* (Emphasis supplied). H. Rept. No. 85, 73rd Cong. 15 (1933).

Although there is no precise indication of legislative intent regarding the meaning of "Any", the first word in § 3(a)(8), it would appear that "Any" was intended to embrace without restriction all policies past or future "issued by corporations under the jurisdiction of a designated insurance supervisor of a State, Territory, or the District of Columbia." *McCormick, supra,* pp. 79-80.

Beyond these requirements Congress did not undertake to otherwise define "Any . . . annuity". Obviously the matter of who bore the investment risk in a particular policy was not used to delineate types of annuities. As in *Haynes* v. *U. S.,* 353 U.S. 81 (1957), Congress intended the exemptive insurance language to have a broad general meaning. As this Court there said:

> "The crucial question is whether the Southern Bell plan should be treated as 'health insurance' within the meaning of § 22 (b)(5). Broadly speaking, health insurance is an undertaking by one person for reasons satisfactory to him to indemnify another for losses caused by illness. We believe that the Southern Bell disability plan comes within the meaning of health insurance.

If Southern Bell had purchased from a commercial insurance company health insurance that provided its employees with precisely the same kind of protection promised under its own plan, the Government concedes that the payments received by ailing employees from the commercial company would not have been taxable. Nevertheless it argues that Southern Bell's plan should not be treated as 'health insurance' because the employees paid no fixed periodic premiums, there was no definite fund created to assure payment of the disability benefits, and the amount and duration of the benefits varied with the length of service. We do not believe that these facts remove the plan from the general category of health insurance. The payment of premiums in a fixed amount at regular intervals is not a necessary element of insurance. Similarly there is no necessity for a definite fund set aside to meet the insurer's obligations. And the fact that the amount and duration of benefits increased with the length of time that an employee worked for Southern Bell reflected the added value to the company of extra years of experience and service. Apparently the Government relies on these facts primarily to show that Southern Bell's plan did not contain features which would be present in the normal commercial insurance contract. The Government, however, offers no persuasive reason why the term 'health insurance' in § 22(b)(5) should be limited to the particular forms of insurance conventionally made available by commercial companies. Certainly there is nothing in the language of § 22(b)(5) which compels this limitation.

There is no support in the legislative history for the Government's argument that Congress intended to restrict the exemption provided in § 22 (b)(5) to 'conventional modes of insurance' and not to include employer disability plans. For

reasons deemed satisfactory, Congress, since 1918, has chosen not to tax receipts from health and accident insurance contracts. The language of § 22(b)(5) appeared in the Revenue Act of 1918 and has reappeared without relevant change in all succeeding revenue acts up to 1954. The term 'health insurance' was not defined in any of these acts or in any of the committee reports. There has been no uniform administrative practice which can be drawn upon to support the narrow meaning of § 22(b)(5) now urged by the Government. Administrative rulings since 1918 appear to have regularly vacillated between holding receipts under company disability plans taxable and holding that they are not taxable. Under these circumstances we see no reason why the term 'health insurance' in § 22(b)(5) should not be given its broad general meaning." pp. 83-85.

In contrast to its attitude toward health insurance in *Haynes,* the Internal Revenue Service has determined that benefits under a variable annuity contract are taxable as amounts received as an annuity. § 1.72-2(b)(3), Federal Income Tax Regulations.

Since 1933 Congress has many times amended the Securities Act but § 3(a)(8) has remained unchanged. § 3 of the Securities Act was amended as recently as August 21, 1958, P.L. 85—699, 85th Cong., 72 Stat. 689. Although variable annuities have been in existence since at least 1952, Congress has not extended the jurisdiction of the SEC to variable annuities. The attitude of the Chairman of the House Committee having jurisdiction over federal securities regulation, House Interstate and Foreign Commerce Committee, has been made public:

"The concept of an agency of limited powers granted by law appears to be a difficult one to

> comprehend, and it is frequently replaced by the notion that the agency is empowered to control anything which the practicalities of the situation as the agency views them appear to warrant. Put differently, the notion seems to be with some thinking that as an industry grows or as new technologies are developed the agency's powers expand or change accordingly. I am thinking of the power of the Federal Communications Commission to authorize and regulate subscription television; the power of the Federal Trade Commission to regulate advertising by insurance companies; and the power of the Securities and Exchange Commission to regulate variable annuities under life insurance policies." *Federal Bar News,* V. 5, No. 10, October, 1958, p. 298.

SEC takes the position that "§ 3(a)(8) was not specifically designed to encompass 'variable annuities' since there were no variable annuities in 1933 when the Act was adopted." Br. p. 39. Respondent agrees that Congress did not specifically draft § 3(a)(8) to encompass the variable annuity. Congress designed § 3(a)(8) to exempt "Any" annuity issued by a life insurance company under the jurisdiction of an insurance supervisor. As is the case in the Bankruptcy Act, Congress has delegated to the states the power to define "insurance" and "annuity" and "subjects that meaning to change as those [state] laws change". *In re Union Guarantee & Mortgage Co.,* 75 F. (2d) 984, 985, cert. den., 296 U.S. 594. It is submitted that "Any" in the context of the statute applies to all annuity policies past, present and future where such annuity is issued by an insurance company under the jurisdiction of an insurance supervisor unless and until, as the Court of Appeals held, "Congress should in plain terms exert its power over some or all aspects of it [insurance business]." (R. 891).

SEC asserts that the differences between the variable annuity and annuities issued in 1933 eliminates the reason for the statutory exemption. Br. p. 39. SEC is, of course, entitled to its opinion regarding § 3(a)(8) and the reasons underlying the fact that it has never been amended by Congress but, it is submitted that such opinion cannot excise the Subsection or extend the reach of the statute. As the District Court held, "Congress only can make such contracts and companies amenable to the regulations of SEC." (R. 94). "The expertise possessed by an administrative agency, however, does not empower it to rewrite the laws which it has been charged with enforcing. This is the function of Congress." *Atalanta Trading Corp.* v. *FTC,* 258 F. (2d) 365, 374 (1958).

SEC v. *Ralston Purina Co.,* 346 U.S. 119 (1953), is the principal legal authority relied upon by SEC to establish its argument that

> The need of a purchaser of a variable annuity for information with which to assess his investment risk is important not only in determining whether the variable annuity is a security but also in determining whether it is exempt from registration. SEC Br. p. 38.

In the *Ralston* case stock of the company was regularly offered to certain of its employees. There was no question but that this stock was a "security". The issue in the case was whether or not the company's stock offerings to its employees involved a "public offering" as that term is used in § 4(1) of the Securities Act. § 4 of the Act deals with exempt transactions; § 3 of the Act, herein involved, deals with exempt securities. The scope of the 4(1) private offering

exemption is not spelled out in the Securities Act. However, the purpose of the exemption was to exempt transactions where there is no "practical need" for the offerees to have the information which registration would disclose. Accordingly, this Court held that there is an affirmative burden on the claimant for a private offering exemption to show that the offerees do not need such information.

In contrast, § 3 of the Securities Act deals with "classes of securities" which are exempt from the Act. In § 3(a)(8) Congress has by clear implication resolved the matter of which agency shall protect the public interest by making the tests of exemption solely dependent upon state action. Congress seems to be satisfied that state regulation of insurance protects the public interest. As it has been said ". . . . the business of insurance has been more generally regulated than any other sphere of business activity not a public utility." *American Hospital & Life Insurance Co.* v. *FTC,* 243 F. (2d) 719, 721, aff'd 357 U.S. 560.

SEC cites *Ralston* for the proposition that the specific tests for the insurance exemption in § 3(a)(8) should be determined by "the need of the offerees for the protections afforded by registration." (Br. p. 33). This argument is so completely lacking in support in the language of the statute, its legislative history or any judicial precedent that SEC has resorted to a fallacious analogy between the holding of *Ralston,* regarding § 4(1), and the exemption set forth in § 3(a)(8). *Ralston* stands for the proposition that the claimant for the private offering exemption has the affirmative burden of proving that the offerees do not need to know the information contained in a

registration statement, whereas § 3(a)(8) stands for the proposition that if the claimant for exemption establishes that it is deemed an annuity under state law and that the company issuing it is supervised by state insurance officials, the tests for exemption have been met.

That Congress did not intend SEC to oversee the actions of state legislatures and regulatory agencies seems clear from the fact "Section 3(a)(8), 15 U.S.C. 77c(a)(8), provides *a total country-wide exemption* where the insurance is issued by a company licensed by *any* state authority." (SEC Br., p. 56, fn. 40).

II

THE PURPOSE OF THE EXEMPTION IN THE INVESTMENT COMPANY ACT FOR INSURANCE COMPANIES WAS TO MAKE CERTAIN THAT INSURANCE COMPANIES WOULD NOT BE REGULATED BY SEC

§ 3(c)(3) of the Investment Company Act exempts from the reach of that Act "Any bank or insurance company;". § 2(a)(17) defines "insurance company":

> 'Insurance company' means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

There can be no question but that respondents (1) are organized as insurance companies (F.F. 3-18, R. 94-98) (2) not only are primarily and predominantly engaged in the life insurance business but are restricted by law to "the business of insurance ap-

pertaining to persons." Title 35, § 501(d), D.C. Code. (F.F. 4, 18, R. 95, 98) (3) are subject to the supervision of one or more insurance commissioners. (F.F. 3-21, R. 94-99) The requirements of the exemption are definite and specific. It is likewise definite and specific that respondents meet all such requirements.

SEC disregards the tests of the statute and the evidence and argues that these exemptive tests "must be construed in the light of the 'dominating general purpose' of the Act." (Br. p. 49) As contrasted with the nebulous "dominating general purpose" of the Act, Loss in his book "Securities Regulation" sets forth, quoting the 10th Annual Report of the SEC, five main purposes of the Act. First: Regulation of selling practices of investment companies. Second: Honest and unbiased management. Third: Greater participation in management by security holders. Fourth: Adequate and feasible capital structures. Fifth: Financial statements and accounting. Loss, *supra,* pp. 99-101.

The legislative history of the Investment Company Act sheds further light on the purpose of the Act.

In 1935 Congress authorized SEC to make a thorough study of the abuses in "investment companies." Public Utility Holding Company Act, § 30. In 1938-40 SEC published its comprehensive *Report on Investment Trusts and Investment Companies.* This Report (Part I, H. Doc. No. 707, 75th Cong., p. 33, fn. 30) reflected that the SEC, specifically directed to study "investment companies," had excluded insurance companies selling annuity contracts or life annuities from the survey because they "were deemed to be without the purview of the study, and therefore not included in the survey."

The SEC recommendations were embodied in S. 3580, introduced March 1940. In extensive public hearings, spokesmen for the securities industry criticized the proposed bill. After conferences between investment trust representatives and SEC, compromise measures were substituted which satisfied SEC and the industry. *Hearings before Subcommittee of Committee on Interstate and Foreign Commerce on H. R. 10065,* 76th Cong. (1940); *S. Rept. No. 1775,* 76th Cong. (1940); *H. Rept. No. 2639,* 76th Cong. (1940). The House and the Senate passed the bills unanimously, with little discussion.

Nothing in this history hints that Congress intended to superimpose federal on state insurance regulation. The following exchange, in August, 1940, between Senator Wagner, sponsor of the bill, and Senator Byrnes, is significant:

> "Mr. Byrnes: Mr. President, the bill has nothing to do with the regulation of insurance companies?
>
> "Mr. Wagner: Of course not." 86 *Cong. Rec.* 10071.

David Schenker, Chief Counsel for SEC, testified:

> "There we go on to say any bank or insurance company is exempt, and we have to make that specific exemption because fire-insurance companies invest and reinvest in securities, as do also insurance companies and banks."
>
> *Hearings before Subcommittee of the Committee on Banking and Currency on S. 3580, 76th Cong.,* pp. 176-177 (1940).

Fire insurance companies, where the amount of the benefit payable is necessarily variable and unknown

until after the loss, have for a long period been permitted by law to invest, and have invested a substantial portion of their assets, in stock and equity type securities.

In June, 1940 Mr. Schenker again stated:

> "Now, we have, in order to be meticulously careful, specifically excluded some types of companies from the purview of this bill . . . Paragraph 3 excludes banks, insurance companies, and savings and loan associations."
>
> *Hearings on H.R. 10065, supra,* p. 102.

As far as insurance companies are concerned with the Investment Company Act, the dominating purpose of the Act was to exclude them from the scope of the Act. The reason for this exclusion, apart from the basic differences between insurance companies and investment companies, was the fact that insurance companies were already subject to adequate governmental supervision while, as the Act states, § 1(a)(5), effective state regulation of investment companies was difficult if not impossible.

As stated in an informed comment:

> It is illuminating to notice that while investment companies bear a close resemblance to savings banks and insurance companies (indeed, some of the earliest investment companies developed as offshoots to insurance companies), yet legislative curbs comparable to the plethora of regulations which surrounds banks and insurance companies have never been imposed upon investment companies, likewise organizations which like . . . insurance companies . . . are already subject to adequate governmental supervision . . . are not deemed investment companies within the meaning of the Act.

The Investment Company Act of 1940, 41 Col. L. R. 269, 274, 277 (1941).

SEC argues that the Investment Company Act should be construed to embrace respondents because "Purchasers of respondents' variable annuities have no protection comparable to those afforded by the Investment Company Act." (Br. 29) This rash statement indicates SEC's complete lack of any understanding of the business of insurance.

Insurance regulation commences prior to the formation of a company and encompasses every activity of the insurance company on its merits. (F.F. 26, R. 99). In the District of Columbia the Insurance Superintendent is vested with "supervision of all matter pertaining to insurance, insurance companies, . . . subject only to the general supervision of the Commissioners" (L.I.A. § 35-101). His office is public, and records, books and papers on file are public records (L.I.A. § 35-401).

Organization: Proposed articles of incorporation, together with $10,000 bond, are filed with the Superintendent, and newspaper notice is published (L.I.A. § 35-502). The Corporation Counsel examines the proposed articles and, if he so finds, certifies them to be in accordance with law (L.I.A. § 35-503). The Company must deposit securities of not less than $100,000 to protect policyholders (L.I.A. § 35-415, § 35-416). The Superintendent may examine any person under oath, and all books and records, pending organization (L.I.A. § 35-506). He must be satisfied as to the company's qualifications before he authorizes it to act (L.I.A. § 35-404). The Superintendent's certificate of authority to the insurance company (L.I.A. § 35-503)

is on an annual basis (F.F. 6, 8, 9, R. 96), revocable for impropriety (L.I.A. § 35-405). If the Superintendent "finds that public interest would be best served by the continued operation of the company" he may, in lieu of revoking a certificate of authority for causes enumerated, subject such company to a penalty. (L.I.A. § 35-405).

Policies: All life insurance and annuity contracts must be approved by the Superintendent (L.I.A. § 35-705, § 35-708). They must include standard provisions life, L.I.A. § 35-703; annuities, L.I.A. § 35-705). Other provisions are prohibited (L.I.A. § 35-704). All applications, riders, and endorsements relating to annuities must be approved (L.I.A. § 35-705).

Home office operation: The company must keep its principal office and its records in the District (L.I.A. § 35-204). All investments must be in media approved by the Life Insurance Act as lawful for insurance companies (L.I.A. § 35-535).

Sales activities: Respondents, like other life insurance companies, operate through the general agency system. (F.F. 25, R. 99). Each general and soliciting agent must be licensed by the insurance authority of his State/District. (ibid). The applicant for an agent's or broker's license must supply full details, some specified in the law, "and such other information as the Superintendent may require" (L.I.A. § 35-425, § 35-428). An applicant for a broker's license may be subjected to examination (L.I.A. § 35-428). When the Superintendant is satisfied of the qualifications and trustworthiness of the applicant, he issues a license on an annual basis (L.I.A. § 35-425, § 35-428).

Disclosure of basic financial data: Respondents report annually to the Superintendent on the standard form (L.I.A. § 35-406, 407; § 47-1802), recommended by the National Association of Insurance Commissioners. (R. 653). This report, 42 pages each 12" x 19", is "designed to ferret out every fact which the [NAIC] Committees, over the years, have deemed significant," and is on file and available for inspection by any interested party in any state where respondents operate. (R. 268).

Annually the Superintendent examines and certifies the valuation of respondents' policy reserves (L.I.A. § 35-701(a); R. 812). The statute vests in the Superintendent discretion with respect to reserves for life insurance policies providing a varying amount of insurance or varying premiums, for annuities, and for other forms of coverage (L.I.A. § 35-701(c) (2) (b)).

The company, every person having knowledge of it, and all its books and records, are subject at all times to examination (L.I.A. § 35-418). The subpoena power (L.I.A. § 35-412) is supplemented by an immunity statute (L.I.A. § 35-802) which effectively eliminates privilege against self incrimination. The examiner's report to the Superintendent may be published in a newspaper (L.I.A. § 35-418).

Respondents are also subject at intervals to detailed "convention" examinations by a corps of examiners representing states in which they do business. (R. 512).

Sanctions against false or misleading statements. The Life Insurance Act blankets this field:

The company is subject to revocation of authority to do business, its agent to cancellation of license, if any officer, director, general agent, solicitor, broker, or other person falsely represents the terms or benefits of a policy, "or the dividends or shares of surplus to be received thereon", or other facts concerning the company's operation (L.I.A. § 35-714).

Advertising standards are set, and violation is a misdemeanor (L.I.A. § 35-409, § 35-410). Directors are personally liable for any of eight types of misconduct, including false notices or deceiving the public (L.I.A. § 35-526). A director, officer, agent or employee wilfully making any false statement in any statement required by law is subject to imprisonment for 2-10 years (L.I.A. § 35-408). The license of a general agent, agent, or solicitor may be suspended or revoked for any of eight reasons, including misrepresentation or a finding that he is "untrustworthy" (L.I.A. § 35-426).

Protection against impairment of capital: The Superintendent may suspend the authority of any life insurance company to operate when he considers further transaction of business hazardous to policyholders, creditors, or "the public" (L.I.A. § 35-405). After notice and hearing, he may revoke the authority to do business for any of 11 reasons, including insolvency, impairment of capital or surplus, failure to comply with the law, misrepresenting the "terms of any policy", or has "used any name or title of any policy . . . misrepresenting the true nature thereof" (L.I.A. § 35-405). He may apply to the District Court for a show cause order to take possession of the company's property and conduct its business for any of six reasons, ranging from insolvency, to a finding that

further business will be hazardous to policyholders, to a general finding of "activities against public policy" (L.I.A. § 35-419).

It is submitted that the insurance regulation to which respondents are amenable provides far greater protection to policyholders than any statute administered by SEC. It is also submitted that the unsupported and unrealistic SEC assertion that "the possibilities of abuse inherent in the sales of their contracts" (Br. p. 33) should confer jurisdiction upon SEC is without foundation in fact, as well as in law.

The practical thrust of the plea of SEC for jurisdiction over respondents under the Investment Company Act would be to make illegal the variable annuity policies issued by them in conformity with District of Columbia law. § 18(f) of the Investment Company Act, applicable if respondents were classed as an open-end investment company, prohibits the investment company from having any form of senior security. Since respondents' variable annuity policies are claims of creditors against the company they are senior to the rights of stockholders; consequently policies could not be issued. § 18(a)(1)(A) of the Investment Company Act, applicable if respondents were classed as a closed-end investment company, prohibits the issuance of a senior claim unless it has an asset coverage of 300%. No insurance company could operate on such a basis. Insurance reserves are calculated to insure coverage of an anticipated amount of loss and are always only a percentage of insurance-in-force figures. Insurance companies operate on the principle of receiving relatively small premiums from a large group to meet individually unexpected or irregular losses.

SEC now admits for the first time that "respondents would have to alter their structure and the provisions of their present contracts to comply with some of the Act's provisions." Br. p. 54. This admission demonstrates the inherent clash between the differing requirements of the regulatory systems established for the insurance field and for the securities field. It is unthinkable that Congress intended such a clash when it enacted the Investment Company Act. The specific exemption in that Act for insurance companies was obviously intended to prevent the possibility of such a fundamental clash.

As the government recently asserted in Nos. 435 and 436, October Term, 1957, Br. p. 25, where in the field of insurance regulation "there is an obvious collision between federal and state policy . . . Congress has decreed that state policy should be controlling."

III

The McCarran Act Precludes Federal Securities Legislation From Being Superimposed Upon the District of Columbia Life Insurance Act and Making Illegal the Corporate Structure and Policies of Respondents. Congress Has Barred SEC From Regulating the Business of Insurance.

As above set forth, a construction of the federal securities Acts holding respondents subject to the jurisdiction of the SEC would make illegal their corporate structures and policies specifically approved by the Superintendent of Insurance and Corporation Counsel of the District of Columbia under the Life Insurance Act of the District of Columbia. As SEC states, "respondents would have to alter their structure and the provisions of their present contracts to comply with some of the Act's provisions" Br. 54. Such

superimposition of federal securities legislation on existing state insurance regulatory authority flies in the face of the McCarran Act. As this Court said in *Prudential Insurance Company* v. *Benjamin*, 328 U.S. 408 (1946)

> Obviously Congress' purpose was broadly to give support to the *existing and future* state systems for regulating and taxing the business of insurance. This was done in two ways. One was by removing obstructions which might be thought to flow from its own power, whether dormant or exercised, except as otherwise expressly provided in the Act itself or in future legislation. The other was by declaring expressly and affirmatively that continued state regulation and taxation of this business is in the public interest and that the business and all who engage in it 'shall be subject to' the laws of the several states in these respects.
>
> Moreover, in taking this action Congress must have had full knowledge of the nation-wide existence of state systems of regulation and taxation; of the fact that they differ greatly in the scope and character of the regulations imposed and of the taxes exacted; and of the further fact that many, if not all, include features which, to some extent, have not been applied generally to other interstate business. Congress could not have been unacquainted with these facts and its purpose was evidently to throw the whole weight of its power behind the state systems, notwithstanding these variations.
>
> * * * * *
>
> But, though Congress had no purpose to validate unconstitutional provisions of state laws, except in so far as the Constitution itself gives Congress the power to do this by removing obstacles to state action arising from its own action or by consenting to such laws, H. Rep. No. 143, 79th

Cong., 1st Sess., p. 3, *it clearly put the full weight of its power behind existing and future state legislation to sustain it from any attack under the commerce clause* to whatever extent this may be done with the force of that power behind it, *subject only to the exceptions expressly provided for.*

Two conclusions, corollary in character and important for this case, must be drawn from Congress' action and the circumstances in which it was taken. One is that Congress intended to declare, and in effect declared, that *uniformity of regulation, and of state taxation, are not required in reference to the business of insurance, by the national public interest, except in the specific respects otherwise expressly provided for.* pp. 429-430, 430-431. (Emphasis supplied).

SEC professes concern over lack of uniformity occasioned by varying state insurance statutes and interpretations by insurance regulatory officials and courts. Br. p. 47. SEC cites *Spellacy* v. *American Life Insurance Ass'n*, 144 Conn. 346, 131 A. (2d) 834, for the proposition that the states have already differed regarding whether or not their insurance laws authorize variable annuities. Respondent does not challenge the right of the Connecticut Insurance Commissioner, Mr. Spellacy, to interpret and seek enforcement of Connecticut insurance statutes. The action was *not* an attempt to enforce a securities statute and is illustrative of the variations in state insurance laws and the effectiveness of state regulation. The effectiveness of state regulation permitted by the McCarran Act continues to be scrutinized by Congress without apparent dissatisfaction. S. Res. 231, S. Rept. 1200, 85th Congress.

SEC takes the further position that even if it was held that the Securities Act and the Investment Com-

pany Act invalidate, impair or supersede state laws dealing with insurance, "still Section 2 of the McCarran Act (15 U.S.C. 1012) saves them since they 'specifically relate to the business of insurance.'" Br. 60. SEC argues for this construction on the basis of the references to insurance in the Securities Act and the Investment Company Act which references, according to SEC, gave Congressional expression to the extent to which there might be SEC regulation of insurance. Such references to insurance clearly exempt respondents' insurance and annuity policies from the definition of "security" in the Securities Act and clearly include respondents within the definition of "insurance company", exempt from the Investment Company Act. The Congressional intent is clear—reference to insurance in these Acts is solely for the purpose of exempting it from SEC regulation.

SEC also takes the position that Congress intended dual regulation of insurance companies and their policies and that the McCarran Act intended to leave this system untouched. Br. 61. The portions of statutes cited for this conclusion do not sustain it. Congress has never intended or permitted federal securities statutes to regulate insurance.

As the District Court held

> When, however, the Congress passed the McCarran Act and set at naught the decision of the Supreme Court in the case of United States v. South-Eastern Underwriters Association, et al., 322 U.S. 533 (1944), it excluded all Federal agencies from regulatory jurisdiction over all insurance companies and insurance business except such agencies as it then excepted or might in the future except. SEC has not been made an exception.

> In view of the fact that the defendants have been chartered as insurance companies by the District of Columbia and their questioned contracts have been approved by the Insurance Superintendent of the District, and by the insurance departments of certain states, this Court is constrained to hold that the broad, explicit and impelling language of the McCarran Act makes them exempt from Federal regulation unless and until Congress provides otherwise.
>
> The arguments which plaintiffs advance here should be made to the Congress. (R. 90-91).

In affirming this decision the Court of Appeals held

> The statutes which we have quoted above show an unmistakable determination on the part of Congress to leave the insurance business in the control of the States until Congress should in plain terms exert its power over some or all aspects of it. The appellants say that, by definition, the business of the appellees is not insurance. We find no such definition. The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance. (R. 891).

As this Court held in *Wilburn Boat Co.* v. *Fireman's Fund Insurance Co.*, 348 U.S. 310, 319, 320-321 (1955):

> In the *South-Eastern* case, however, all the opinions had emphasized the historical fact that States had always been free to regulate insurance. The measure Congress passed shortly thereafter, known as the McCarran Act, was designed to assure that existing state power to regulate insurance would continue. Accordingly, the Act contains a broad declaration of congressional policy that the continued regulation of insurance by the States is in the public interest, and that silence on

the part of Congress should not be construed to impose any barrier to continued regulation of insurance by the States.

The hearings on the McCarran Act reveal the complexities and difficulties of an attempt to unify insurance law on a nationwide basis, even by Congress. Courts would find such a task far more difficult. Congress in passing laws is not limited to the narrow factual situation of a particular controversy as courts are in deciding lawsuits. And Congress could replace the presently functioning state regulations of marine insurance by one comprehensive Act. Courts, however, could only do it piecemeal, on a case-by-case basis. Such a creeping approach would result in leaving marine insurance largely unregulated for years to come.

* * * * *

Under our present system of diverse state regulations, which is as old as the Union, the insurance business has become one of the great enterprises of the Nation.

Congress has been exceedingly cautious about disturbing this system, even as to marine insurance where congressional power is undoubted. We, like Congress, leave the regulation of marine insurance where it has been—with the States.

CONCLUSION

For the foregoing reasons the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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Nos. 237 and 290

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., *Petitioner*

vs.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY, *Respondents*

SECURITIES AND EXCHANGE COMMISSION, *Petitioner*

vs.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY, *Respondents*

On Writs of Certiorari to the United States Court of Appeals For the District of Columbia Circuit

BRIEF FOR RESPONDENT VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

Nos. 237 and 290

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., *Petitioner*

vs.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY

SECURITIES AND EXCHANGE COMMISSION, *Petitioner*

vs.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY

On Writs of Certiorari to the United States Court of Appeals For the District of Columbia Circuit

BRIEF FOR RESPONDENT VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA

INTRODUCTORY.

These two proceedings result from separate petitions for certiorari by NASD[1] and SEC in a single

[1] Abbreviations used in this Brief: Parties: SEC—Securities and Exchange Commission; NASD—National Association of Securities Dealers, Inc.; VALIC—Variable Annuity Life Insurance Company of America; EALIC—The Equity Annuity Life Insurance Company.

Record: P. Ex. and D. Ex.—trial exhibits of plaintiff or of either defendant; F.F.—trial court Findings of Fact; R.—printed record; Ct. App. Br.—Court of Appeals brief of party indicated; Br.—Supreme Court brief of party indicated.

action in which they sustained adverse judgments in both lower courts. VALIC files this single Brief in response to the separate briefs of SEC and NASD.

QUESTIONS PRESENTED.

VALIC being a life insurance company engaged in the sale of life insurance and variable life annuity policies with the approval and under the supervision of the Superintendent of Insurance of the District of Columbia and of the insurance commissioners of the several States where it operates, did the Court of Appeals err in holding:

(i) that policies issued by VALIC are annuities;

(ii) that VALIC is engaged in the "business of insurance" which is excluded from the regulatory jurisdiction of SEC by the McCarran-Ferguson Insurance Regulation Act (Act of March 9, 1945, c. 20; 59 Stat. 33, as amended; 15 U.S.C. §§ 1011-1015, hereafter sometimes cited "McCarran Act");

(iii) that VALIC is not required to register its policies with SEC under the Securities Act of 1933 (Act of May 27, 1933, c. 38; 48 Stat. 74; 15 U.S.C. §§ 77a *et seq.*, hereafter sometimes cited "1933 Act"); and

(iv) that VALIC is not an "investment company" subject to the Investment Company Act of 1940 (Act of August 22, 1940, c. 868; 54 Stat. 789; 15 U.S.C. §§ 80a-1 *et seq.*, hereafter sometimes cited "1940 Act"), and the requirement thereof which would prohibit the issuance of policies duly approved by the insurance authorities.

STATUTES INVOLVED.

The 1933 and 1940 Acts and the McCarran Act have been set out in the Briefs of SEC and NASD. Title 35 ("Insurance"), District of Columbia Code, 1951 edition, and Supplements thereto, of which chapters 3 to 8, inclusive, deal with the Life Insurance Act, are pertinent herein. Appendix VI to this Brief contains that portion of the Life Insurance Act appertaining to disclosure.

COUNTER-STATEMENT.

The variable life annuity policy [2] provides the annuitant an income for the uncertain period of his life, not in fixed dollar amounts, but in variable dollar amounts determined under the precise provisions of the policy and keyed to the insurance company's investment experience, based upon the scientific application of actuarial principles of life contingencies.

Variable annuity policies are "a means of providing a retirement program under which benefit payments tend to vary with cost of living charges" (*sic.*—Read changes, F.F. 29, R. 100). The problem arises from the impact of cost of living changes on the income of retired persons. One receiving a $2500 pension or retirement income in 1940 would by 1951 have had to receive

---

[2] Note on terminology: SEC at the outset of its Brief refers to VALIC's policies which, says SEC, "they describe as 'variable annuities'" (SEC Br. 3), as though this were a new name invented by VALIC. VALIC will not engage in semantic argument. The name variable annuity, in use for years before VALIC was organized, has been accepted in legislation, court decisions, and insurance textbooks. VALIC describes its operations in what SEC calls "insurance terminology" (SEC Br. 3 fn.) because VALIC is a life insurance company engaged solely in issuing policies guaranteeing life contingencies, and any effort to state its operations in less appropriate language distorts them.

$4500 to have the same purchasing power.[3] An individual's annuity plan is a long-term program which may be in force for fifty years or longer. Long-term trends are the ones that count in retirement planning, not the day-to-day or month-to-month fluctuations of the stock market. The variable annuity policy, which pools and distributes the individual risk of longevity, can be made available to the public only by organized and regulated life insurance companies (R. 441). The expert actuarial mathematics to say nothing of the other insurance techniques and "know-how," on which variable annuity policies are based, dramatically illustrate how far they are from being a security and how far the business of writing and selling them is from that for which SEC has had training or experience.

VALIC's every operation is subject to the pervasive supervision of the insurance officials of the District and the several states in which it is duly authorized to do business.

VALIC, therefore, is not resisting regulation. It is resisting the attempt of SEC to impose on it a regulatory jurisdiction under Acts inapplicable to, and destructive of, its operations, contrary to the clearly expressed intent of Congress.

The facts sharpen by a specific example:

Early in 1957, Grenville Clark, a 74 year old New York attorney, applied to EALIC for a variable annuity policy (D. Ex. 102, R. 306, 877; R. 305, 385).[4] For a $30,000 premium, EALIC issued its policy specifying (a) annual payments for life, ceasing on death, the first due February 1, 1958, the dollar amount of

[3] D. Ex. 30, R. 406, 841, showing Cost of Living Index increase from 60 to 108, or 80%, in the years 1940-1951.

[4] EALIC's policies are substantially identical to VALIC's. F.F. 23, R. 99.

each measured by the value on payment date of 3827.50 annuity units; (b) the value attributed to each annuity unit on November 1, 1956, $1.00; and (c) the precise mathematical formula for adjusting this value thereafter (R. 878). The dollar "amount of the annuity payments," determined in accordance with the provisions of the policy, "will vary with the investment experience of the company," but cannot be affected by company operating expenses or by variations in the company's mortality experience from that of the Progressive Annuity Mortality Table (D. Ex. 102, R. 306, 877, 878).

By this policy:

1. Clark's right to a determinable annual amount, established by his sex and age, continues so long as he lives, regardless of how long this may be; and terminates on his death. SEC experts knew of no "security" having such characteristics (R. 306, 395, 404).

2. Clark's risk of outliving his capital is shifted to the company, which guarantees the mortality assumptions and, subject to such guarantee, distributes the risk among the group of annuitants. Both petitioners conceded below that this is an insurance function (SEC Ct. App. Br. 15, 31-32; NASD Ct. App. Br. 35-56). SEC recognizes "the mortality feature which determines the duration of payments by the companies" (SEC Br. 11, see also 13, 16).[5]

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[5] NASD (Br. 20, 42) still asserts that the variable annuity policy does not shift even the risk of loss attendant on the contingency of longevity. But NASD admits however (Br. 45) that by VALIC's guarantee of mortality, it takes "the calculated risk" that excessive longevity (which NASD translates as usual to inappropriate securities terminology) "may require it [VALIC] to dip into its surplus, if any, or the capital contributions of its shareholders." This admission concedes VALIC's assumption of the mortality risk inherent in its policies.

I

VALIC IS A LIFE INSURANCE COMPANY WITH CORPORATE AUTHORITY LIMITED SOLELY TO THE BUSINESS OF INSURANCE APPERTAINING TO PERSONS.[6]

VALIC is a stock life insurance company, capital and unassigned surplus over $600,000, authorized since December 30, 1955[7] to transact business under the Life Insurance Act (District of Columbia Code, 1951 ed., Title 35, chapters 3-8, hereafter cited "L.I.A.").

The Corporation Counsel of the District of Columbia on three occasions, has certified (as required by L.I.A. § 35-503) that VALIC's purposes and corporate structure conform to District insurance law. SEC does not contend otherwise.

VALIC (complying with L.I.A. § 35-415) deposited with the Superintendent of Insurance of the District of Columbia (hereafter "Insurance Superintendent"), for the benefit of its policyholders, securities initially valued at $100,000, later increased to over $200,000. VALIC's Articles of Incorporation and amendments were approved by the Insurance Superintendent, and VALIC was authorized to do business (L.I.A. §§ 35-503, 35-705).

The policies issued by VALIC have been approved by the Insurance Superintendent (L.I.A. § 35-705) (R. 506) "for sale as annuity contracts" (SEC Pet. for Cert., p. 3).

Prior to the trial, insurance commissioners of West Virginia, Kentucky, and Arkansas had authorized VALIC to transact its insurance business in those

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[6] The authorities for this summary are F.F. 3-16, 19-21, and 27; R. 94-100, R. 506; and D. Exs. 2, 4 (not printed), 6, 8, 13, 15, 20, R. 406, 814, 817, 823, 832. They will not be individually cited.

[7] The statement (NASD Br. 4) that "VALIC was first 'authorized to transact' " its business in the District on April 30, 1956 is one of many factual errors in the Petitioners' Briefs. See F.F. 5-6, R. 95-96.

states, and also had approved its policy forms. Since the trial, VALIC has been authorized to operate in Alabama[8] and New Mexico.[9] EALIC has been authorized to do business in North Dakota.[10] State insurance statutes and regulations provide for detailed supervision of VALIC by the respective insurance authorities.

VALIC's policies are offered to individuals and groups through the general agency system commonly used by life insurance companies. "Every general agent and every agent selling any VALIC policy [is] and must be licensed by the Insurance Department in either the District of Columbia or the State in which VALIC operates" (F.F. 25, R. 99).

In the District and in Kentucky, annuity premiums paid to VALIC are subject to state tax of 2%; in Arkansas, 2½%; in West Virginia, 1% (F.F. 27, R. 99-100); in Alabama, 1%; and in New Mexico, 2%.

II

VALIC'S POLICIES.

VALIC's seven approved annuity policies fall into two categories, individual and group (F.F. 31, R. 101).

A. GENERAL.

1. Annuity benefits.

Each VALIC policy obligates it to pay an annuity in amounts determined pursuant to the contract, continuing for the life of the annuitant.[1] All the assets

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[8] Copy of Alabama certificate of authority is printed as Appendix II hereto, p. 6a.

[9] Copy of New Mexico certificate of authority is printed as Appendix III hereto, p. 7a.

[10] Copy of North Dakota certificate of authority is printed as Appendix IV hereto, p. 8a.

[1] For brevity, VALIC throughout this brief will discuss the issues in terms of the straight life annuity, without refund at

of the company stand behind this obligation (SEC expert, R. 282, 296).

From the standpoint of actuarial principles, variable and fixed-dollar annuities are identical (R. 470, 487). The essential function of the issuing life insurance company is to liquidate the company's aggregate liability to the annuitant group over the uncertain life spans of the individual policyholders, some of whom (unidentifiable in advance) will die early and some of whom will live long.[2] Reserves released on early death are available to assure payments to the long-lived (R. 458-459). "The company has to have some mortality profit on early deaths to offset the loss on deaths later on" (SEC expert, R. 255). Under VALIC annuities:

> ". . . payments to the annuitant are calculated pursuant to actuarial principles of life contingencies predicated upon an assumed annual investment increment rate in such manner that the annuity payments will remain uniform in dollar amount if actual investment experience conforms to the assumed investment increment rate. The contracts provide that the amount of the payments to the annuitant will vary only to the extent that the actual investment experience varies from the

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death. VALIC offers the annuitant options (customary in insurance annuities (SEC expert, R. 233)), providing payments (a) over the longer of two lives, or (b) over a 10 year period certain and thereafter for life. Involving identical actuarial principles, these need not be discussed separately.

SEC's insurance expert confirmed that VALIC's policy provisions were common to virtually all deferred or optional life insurance annuities: maturity date, election of an alternate maturity date by the annuitant, monthly annuity payments, cash surrender values, option to terminate in advance of annuity, payments to beneficiaries on annuitant's death during premium payment period, policy loans, non-forfeitures, misstatement of age, etc. (R. 232-238).

[2] SEC recognizes VALIC's obligation to pay for life, though such life exceeds normal expectancy (Br. 8).

assumed investment increment rate" (F.F. 30, R. 100-101).

The actuarial problem involved in the liquidation of the group liability is to schedule the annuity payments on a basis fair both to the short- and the long-lived. To do this, actuaries must base their calculations on a realistic assumed net investment rate and a conservative mortality table (R. 496. See SEC expert, R. 177).[3]

The assumed investment rate: The actuary uses an assumed investment rate to assure that each annuitant will participate equitably both in the assets underlying the reserves for future annuity payments, and in the earnings thereon pending the ultimate liquidation of those assets. Should the actuary ignore expected earnings, initial annuity payments would be too low. Later annuity payments would have to increase to liquidate the group reserve at the death of the last survivor (R. 495-496). The opposite inequity would arise from use of an unduly liberal assumption in calculating the initial payment.

VALIC uses an assumed net investment rate of 3½ per cent per annum in the actuarial calculation of

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[3] No useful purpose would be served by an elaborate discussion of actuarial mathematics. Though SEC thinks that VALIC's contract provisions involve a "rather complicated formula" (SEC Br. 23 fn), SEC's insurance actuary confirmed that all amounts were precisely determinable as the occasion for calculation arose (R. 254). The trial court found that the amount of the annuity payments is prescribed by contract (F.F. 30, R. 100-101).

Actuarial calculations involve an advanced field of mathematics. Admission to the Society of Actuaries is based on a comprehensive examination. The mathematical parts of the examination "include advanced algebra with special emphasis upon the theory of probability, the theory of compound interest, finite differences, the differential and integral calculus, and statistics." 1 ENCYCLOPEDIA BRITANNICA 145 (1948) "Actuary."

the initial annuity payment. This assumption is built into the initial and all subsequent annuity payments, so that if the net investment rate of VALIC were at all times precisely 3½ per cent, the amount of the annuity payments would not vary. The net earnings rate of United States life insurance companies for 1915-1957 averaged over 4 per cent.[4] SEC has admitted (SEC Ct. App. Br. 7) that VALIC's assumption of 3½ per cent "is made to take care of such normal income as might be anticipated."[5]

Although no witness criticised VALIC's actuarial calculations, NASD seeks to imply that VALIC assumes no substantial mortality risk (NASD Br. 44, fn. 1 because VALIC annuity payments are "less than $10 per $1000". (NASD Br. 44). The record shows that VALIC's annuity obligations, as approved by the several insurance commissioners, are in accordance with current practice of other life insurance companies. The amounts, of course, depend on the age and sex of the annuitant or annuitants (joint and survivor) and the option selected. On a straight life annuity, the initial monthly payment ranges from $4.28 per month for a 50 year old female to $8.22 per month for a 70 year old male (P. Ex. 1, R. 125, 567 at 568-569). The initial monthly payment of $6.81 for a 65 year old male compares to $6.75 and $6.50 provided respectively by Lincoln National Life Insurance Co.

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[4] 1958 LIFE INSURANCE FACT BOOK, p. 59.

[5] P. Ex. 4, R. 142, 647, shows that during the first six months of the Series 2 policies, VALIC's net investment rate was 1.7 per cent; during the year ended March 31, 1957, it was 3.8351 per cent. *Misstatement:* NASD Br. 44, fn. 3, asserts that VALIC's counsel "conceded" that VALIC had "never earned as much as 3½ per cent on its funds." The source cited (R. 545-546) shows that VALIC's counsel, answering an inquiry by NASD counsel, pointed out that the net investment factor on VALIC operations was shown in P. Ex. 4.

and Canada Life Assurance Co. (D. Ex. 41, R. 547, 853).

Mortality table: All VALIC policies guarantee that annuity payments will continue for the life of each annuitant (F.F. 30, 33-A-i, R. 100-101, 102; SEC expert, R. 255). VALIC assumes this guarantee the day it issues the policy, though annuity payments may not commence for decades (F.F. 33-A-i, R. 102; R. 461, 463-465, 494; SEC expert, R. 248-250).[6]

Improved life expectancy over the past 70 years evidences the significance of this mortality guarantee. The Society of Actuaries has published numerous revised mortality tables reflecting decreased mortality (SEC expert, R. 250-251). ". . . The 1941-58 increase [in life expectancy], largely a result of antibiotics and other medical advances, is about equal to the life expectancy increase in the United States between 1858 and 1941."[7] A life annuity policy written by a life insurance company in 1910, maturing in 1950, calculated on the American Experience Table of 1868,[8] would commit the company to payments substantially in excess of those justified by present experience (SEC

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[6] VALIC's annuity obligation is quite unlike the commitment of the insurance company (referred to SEC Br. 32) which purports to offer stockholders of Advisers Fund, Inc. an opportunity at some future date to obtain a fixed-dollar annuity, but ". . . reserves the right to withdraw the offer or modify the rates or other terms of the commitment with respect only to the proceeds from liquidation of shares acquired subsequent to due written notice sent to the affected stockholders . . ." (P. Ex. 48, R. 805 at 808). SEC recognizes (Br. 32) that an investment company cannot issue a life annuity but must operate under "arrangements with an insurance company." The insurance company receives the premium and "converts" the value to an annuity, and the annuity policy is not registered with SEC.

[7] TIME MAGAZINE, December 29, 1958, p. 13.

[8] 10 TRAN ACTUARIAL SOCIETY OF AMERICA, 509-514.

expert, R. 247-249).[9] The Progressive Annuity Mortality Table[10] used by VALIC's actuaries was designed for use in annuity calculations (SEC expert, R. 252-253), and "gives effect to the guarantee that such payments will be continued during the status [i.e., life] for which the contract provides" (SEC expert, R. 194).

Each VALIC policy, at issuance, fixes the amount of the initial annuity payment in dollars per $1000 of reserve applied. This amount is reported to the policyholder at the inception of annuity payments in terms of "annuity units". Annuity units are statistical reporting symbols which are not a part of the company books of account (F.F. 37, R. 105). When annuity payments begin, the number of annuity units remains fixed (P. Ex. 1, R. 125, 567, at 573, par. 20).

2. Standard policy provisions.

VALIC's annuity policies include the "Standard Provisions for Annuity Contracts" required by L.I.A. § 35-705 when appropriate to the type of policy (F.F. 34, R. 104; P. Ex. 1, R. 572-574).

B. TYPES OF POLICIES.

1. Individual annuity policies.

a. Immediate Life Annuities.

VALIC's three forms of single premium immediate individual life annuity policies (P. Exs. 7, 8, 9, R. 206-208, 677-688), as their title makes clear, involve no

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[9] NASD states that VALIC's mortality guarantee "is meaningless" (Br. 16). But NASD says (Br. 17), "experienced departures from the expected mortality . . . in the direction of longer . . . life, could have no effect on the operation of the basic formula which describes VALIC's obligation to pay under its contract." Precisely because such departures do not change the amount of VALIC's contractual annuity payments, VALIC's guarantee shifts the risk of increased longevity from the annuitants to VALIC.

[10] Published in ANNUITY TABLES, SOCIETY OF ACTUARIES (1952).

period of premium payments. They become payment obligations forthwith. The actuarial techniques, which are those for determining the annuity payments, have been described above.

b. Deferred [Optional] Life Annuities.

Most individuals must acquire their life insurance estate and their annuity for retirement by premium payments spanning their productive years.[1] The standard life insurance procedure on deferred annuities is to accumulate as a "sinking fund" reserve the net premium applied to provide annuity benefits (SEC expert, R. 188-189, 278), and to determine interim cash values by adjusting such accumulating amounts by investment results (R. 526-529). The only difference between a participating fixed-dollar annuity and a variable annuity is that the former adjusts by an assumed investment rate, 2 per cent to 2½ per cent, and distributes part of the excess as dividends; the variable annuity adjusts reserves by actual investment experience (R. 471, 497).[2]

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[1] 98 per cent of all ordinary life insurance is bought on a premium payable annually or more frequently (1956 LIFE INSURANCE FACT BOOK, Ct. Ex. 1, p. 20). 75 per cent of individual deferred annuity policies are in the pay-in period (id., p. 81).

[2] D. Ex. 41, R. 537, 853, shows the parallel between the cash value on fixed-dollar and variable annuity policies. Two typical fixed-dollar, participating policies are compared with a VALIC policy. It is assumed that (a) on the fixed-dollar policies, dividends at the current rate accumulate at interest; and (b) on the VALIC policy, the net investment rate averages 3½% per annum. On identical assumptions of age, sex, and premium, typical cash values are:

	Lincoln National	Canada Life	VALIC
After 5 years	4,557.80	4,413.80	4,409.06
10 years	10,351.20	10,221.50	10,176.22
20 years	24,910.20	24,775.70	25,525.20
30 years	44,569.10	44,275.80	46,902.52

NASD charges that VALIC cannot comply with the reserve requirements of District insurance law (Br. 36). This conflicts with the certificate of the Insurance Superintendent, who periodically examines and certifies VALIC's reserves (D. Ex. 1, R. 270). It conflicts with the testimony of SEC's insurance expert, who emphasized that he questioned neither the method of calculation nor the adequacy of VALIC's reserves (R. 275). It conflicts with the testimony of Maclean (R. 486-487), the distinguished actuary recognized by seven citations in the NASD Brief. Of a similar charge made by NASD in a brief recently filed in West Virginia, the Insurance Commissioner of West Virginia has stated:

> "The Insurance Commissioner [of West Virginia] has caused to be valued on two separate occasions, 1956 and 1957, the reserves maintained by the defendant [VALIC]. The reserves have been found to be an accurate reflection of the Company's policy liabilities."[3]

VALIC reports annually to each policyholder the amount of the accumulated cash value of his policy. This is analogous to reports by participating companies with respect to dividends or excess interest payments (R. 527). In these reports, VALIC uses "a statistical device referred to as an 'accumulation unit' [which] . . . is a symbol designed and used for the purpose of keeping the policyholder informed as to the cash surrender value of his policy and the investment experience of the company. . . . VALIC has no account reflecting 'accumulation units' " (F.F. 36, R. 105). VALIC's books of account, like those of

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[3] Brief of *Amicus Curiae* on behalf of C. Judson Pearson, Insurance Commissioner, in *State ex rel. Sims, Commissioner of Securities* v. *VALIC*, Cause No. 24,449, Circuit Court, Kanawha County, West Virginia. This case is hereinafter discussed.

any other life insurance company, are kept on a cash basis (R. 524). Save for its use as a reporting symbol, the accumulation unit has no function (R. 525, 565).

SEC, in various shades of language, contends that "accumulation units" or "annuity units" represent the individual policyholder's "aliquot share" or "interest" in a "fund" of securities "purchased with his money" (e.g. SEC Br. 5, 6, 16, 36). These contentions ignore the relation between an insurance company and its policyholders. Each annuity purchaser buys protection against longevity, for which he pays a total consideration, part in cash premiums and part in his agreement that the company's liability with respect to his policy terminates at his death. VALIC undertakes the mortality guarantee and receives the premium. Like any insurance company, it balances its inflow of cash with its outgo for expenses and policy liabilities. When excess cash develops, it invests those funds in media legal for life insurance companies under the District Life Insurance Act. Over $100,000 of its assets were on deposit with the Insurance Superintendent before there was a policyholder: how does a policyholder acquire an "aliquot" share in these securities?

VALIC's reserves are adjusted upon the net investment experience of all its investable assets, including assets derived from the stockholders. Yet in the event of excessive longevity of the group, the stockholders supply the funds to satisfy VALIC's mortality guarantee (conceded, NASD Br. 45): in such event does the annuitant's "aliquot part" increase? And finally, at the annuitant's death, with liability ceasing, does his "aliquot share" evaporate?

The basic fact is that VALIC has no "fund" as that term is used in the Investment Company Act of

1940. An annuitant has no "interest" or "aliquot share" in VALIC's assets, or in any part thereof. An annuitant, like any creditor or other holder of a contract obligation, owns no part or share of the obligor's assets. Count Three of the original Complaint (R. 6) proceeded on the theory that VALIC had a "fund." Finding the charge groundless, SEC explicitly abandoned it (SEC Trial Brief 71; SEC Ct. App. Br. 3, fn. 3).[4]

Examination of the structure of United Fund, Inc. which SEC claims is "similar to" VALIC (SEC Br. 31), shows the fundamental difference between an investment company and VALIC or any other life insurance company.

When the United Fund Prospectus (P. Ex. 15, R. 341, 726) is examined closely, the organization and affiliation of these corporate or individual entities

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[4] A flagrant inaccuracy appears when NASD (Br. 8) asserts that "VALIC's expert witness, Maclean, testified that VALIC's operations during the premium payment period are similar to those of an investment company" (R. 492-493). We quote Maclean's testimony at the cited source:

"Q. [By NASD counsel]. Well, doesn't that operation in the accumulation period of VALIC appear similar to what you believe the investment companies do?

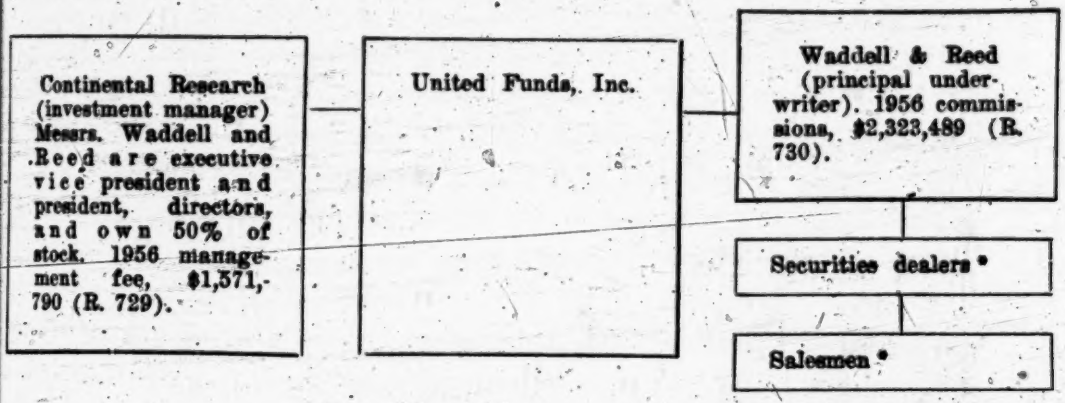
"A. Oh, no. As I understand it, it is quite different. . . . It is an entirely different thing."

NASD counsel then assumed facts not in the record:

"Q. If I told you there are investment companies which invest and reinvest your funds, would that change your answer?

"A. That would change it to this extent: that during the accumulation period, they are very similar to what happens in the Equitable Life Assurance Company or any other company, because that is what they do."

emerges, and the organization chart would look like this:



* 1956 commissions, $5,069,846 (R. 730).

The investor pays the sales organization set up by the PRINCIPAL UNDERWRITER. The UNDERWRITER deducts his commission and remits net to the FUND. The investor receives his shares as evidence of his ownership of part of the FUND, and no life contingency can or does enter into the realization of his investment. The FUND makes payment of approximately one-half per cent of total assets to the INVESTMENT MANAGER. The INVESTMENT MANAGER and the UNDERWRITER take no risk with respect to the FUND. They are independent contractors whose obligations cease at the dispensing of their services. The UNDERWRITER and the INVESTMENT MANAGER, who continue at their option and at the sufferance of the FUND, can pass out of existence as entities, and the FUND is not affected. Conversely the FUND can depreciate in value, and the INVESTMENT MANAGER and the UNDERWRITER continue to prosper. Their assets offer no benefit or protection to the fund share holder.

In contrast, the stockholders of VALIC create the capital and surplus of the company, all of which stands for the primary protection of the policyholders. All of VALIC's assets stand behind all of its liabilities.

The results of VALIC's investment of all its assets are reflected in the policy benefits. No portion of its assets are considered separately. It stands as a single entity and cannot dismiss its responsibilities until the last benefit is paid to the last living annuitant or his beneficiaries. Purchasers transact all business directly with VALIC. There are no intermediaries. Hence policyholders look solely to the Company for fulfillment of its contractual obligations.

Contractual provisions for expenses, contingencies, and company profit: In balancing the in and out flow of cash, VALIC's contracts must provide a source of funds for expenses, contingencies, and perhaps profit to stockholders. Since both SEC and NASD mislabel the policy provisions which give rise to funds for these purposes, a brief analysis is necessary.

VALIC's individual deferred life annuity policy provides that a percentage of the basic annuity premium will be applied to provide the annuity benefits. SEC (Br. 4), calls the difference "loading charges" and, in conflict with the undisputed record, mislabels it "sales expense."

All VALIC policies provide for an adjustment of gross investment results by .0015 monthly in determining the net investment rate employed to adjust reserves and annuity payments. SEC (also in conflict with the record) labels this adjustment a "management fee" (Br. 23).

A complete answer is that the provisions are unambiguous and are approved by the insurance commissioners who have authorized the sale of the policies. But that might be claimed to "assume what is sought to be proved" (SEC Br. 3 fn.), so VALIC will examine the SEC use of terminology.

An actuary calculating premiums considers the policy as a whole and must provide "the proper mar-

gins . . . to cover" all corporate requirements during the long term that the policy is in effect (R. 547). During that period, VALIC must pay all corporate expenses, all taxes,[5] all contingencies incident to possible changes in expenses[6] and mortality, and (it is hoped) some profit for stockholders. How does it obtain revenue for these inclusive corporate purposes?

Examine a hypothetical case, using VALIC's General Information and Rate Book (Pl. Ex. 2, R. 126, 579 at 619):

Assume a 35 year old male purchases a deferred life annuity providing minimum life insurance and annuity payments beginning at age 65. He also can obtain waiver of premium protection in the event of disability, but this does not appear to be under attack and may be ignored in the interest of simplification. At 65, he begins to receive annuity payments. He then has a life expectancy of something over 16 years. He dies at 81. The policy has been in force 46 years.

The $30,000 aggregate of premiums will be applied as follows:

For annuity benefits	$26,745
For life insurance benefits	105
For premium taxes (R. 244-245), average	600

[5] VALIC's Series II policies provide that taxes measured by income should be deducted in the calculation of the net investment factor (e.g., P. Ex. 1, R. 125, 567 at 573, par. 18).

Since the trial, with the approval of the Insurance Superintendent, VALIC has modified its policy by deleting the provision referring to such taxes. A copy of the endorsement which VALIC attaches to all policies is printed as Appendix IV, p. 4a.

[6] "The basic problem that inflation creates for life insurance companies is the increasing inadequacy of the expense loading on existing policies. . . . The current practice in stable times is to build up a general contingency reserve that will help to cover future costs that will not be met by the emerging expense loading." Gold, Inflation and Life Insurance (1957) TRANS. SOC. OF ACTUARIES, Vol. VIII, p. 315.

This leaves $2,550 to be applied during the 46 years the policy is in force, toward the payment of all other taxes, all sales and general corporate expenses, all contingencies, and any corporate profit. This will be supplemented (R. 546-547) by the .0015 monthly provided in the contractual provisions for determining VALIC's net investment rate.

Thus SEC attempts to compare (i) sources of revenue to meet VALIC's expenses, contingencies, and profits; with (ii) limitation on "sales load" of investment companies (1940 Act, § 27), which "sales load" pays none of the investment trust's operating expenses (SEC expert, R. 310). On this inapposite base, SEC then makes the erroneous statement that VALIC's "charges are in excess of those permitted under Section 27" (SEC Br. 29).

SEC's "speculation" argument: Similarly groundless is SEC's effort to argue that VALIC's annuity policies are or can be devices for "speculation." Here SEC coins a special definition for the word "speculation" (SEC Br. 21, fn. 13). Even this artificial definition collapses, however, when one reads the short testimony of VALIC policyholders (R. 360-374, summarized pp. 27-28, *infra*) as to their motives in purchasing their policies.

Established life insurance practice contemplates that a substantial part of the total company allowance for expenses and contingencies will be received from premiums during the early years of the policy life. It requires some eleven years for the cash value of an annual-premium fixed-dollar deferred annuity to equal the aggregate (without interest) of premiums paid, and it will take the same period for VALIC's equivalent annuity if VALIC's net investment rate averages 3½ per cent annually (D. Ex. 41, R. 537, 853, quoted in part on p. 13, *supra*). This established

industry practice makes it impractical to use a life annuity or insurance policy for "speculation," and gives important economic encouragement to the initiation and continuance of the long-range program involved in retirement planning.[1] What "speculator" would be willing to pay the premium incident to the mortality risk, which represents a substantial part of policy cost, in order to "speculate" when he can buy investment trust shares from many eager sellers without any of his payment being made for the insurance mortality guarantees?

Common sense, therefore, refutes the scare talk of "speculation." Nevertheless, VALIC considers the SEC generalizations:

Advance premiums: All insurance policies customarily provide for payment of premiums "on or before" due date (SEC expert, R. 242). VALIC will not accept advance premiums beyond the current year (R. 512). A "speculation" argument resting on the common right of a policyholder to pay an annual premium hardly merits comment.

Grace period: The District Insurance Laws require a 30 day grace period (L. I. A. § 35-705). The argu-

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[1] Income and estate taxes make unrealistic an argument that a variable annuity can be used for "speculation." Illustrations:

A gain over cost when an annuitant takes the cash surrender value of his policy is taxed as ordinary income, not as capital gain. I. R. C. § 72(e); U. S. Treas. Reg. § 1-72-11 (1956).

If a policyholder dies, any excess of the cash value of his policy over premiums paid, realized at death, will be taxed both as ordinary income and as part of his estate. Any survivor annuity is included in the gross estate at replacement cost, including "loading." I. R. C. § 2039(a); U. S. Treas. Reg. 20.2031-8, 20.2039-1. Proceeds payable to a beneficiary or to the estate are included in the gross estate. I. R. C. § 2039(a). But the survivor, beneficiary, or estate does not receive a stepped up basis for later taxation. (I. R. C. § 1014(b)(9)(A)).

ment that this period could or would be used for "speculation" merits even less comment.

Cash surrender value: State insurance laws require that insurance policies include non-forfeiture provisions. In the District, an annuity purchaser who fails to pay premiums must, as a minimum, be issued a paid-up annuity (L. I. A. § 35-705).[8] In many states, cash surrender values are required, and such a provision appears "in the vast majority" of deferred annuities (SEC expert, R. 233). In the Securities Act of 1933, § 3(a)(8) refers to the "optional annuity contract," which is merely another term for a deferred annuity policy containing the usual provision allowing an annuitant or a beneficiary to elect whether to take the cash surrender value instead of the life annuity. The provision protects the policyholder, whose personal or family needs may indicate the necessity or desirability of foregoing his retirement annuity to receive immediate funds. Since it will be years before the surrender value would equal the aggregate premiums, and since any ultimate excess will be taxed as ordinary income, there is little motivation to buy in order to cash in. There is not the slightest indication in the record that any VALIC policyholder ever intended to, attempted to, or could use the right to forfeit his annuity protection as a means of "speculation."

Loans: A VALIC policyholder may borrow on his policy only during the premium payment period, and only the lesser of total premium payments or cash sur-

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[8] NASD Br. 34 criticises VALIC because failure to pay a VALIC premium does not forfeit the purchaser's cash surrender value "as it would forfeit an insurance policy." Here NASD (i) is ignorant of the requirements of the Life Insurance Act; and (ii) is unaware of the difference between lapsing a policy (which occurs) and forfeiting the cash surrender value thereof (which under L. I. A. cannot occur).

render value: he can never borrow more than he has paid in (P. Ex. 1, R. 125, 567). The argument that one would buy for "speculation" a contract with such limitations on emergency loans is far fetched. No policyholder had ever sought a loan (R. 551).

(i) Life insurance and disability premium waiver.

Unless the applicant is uninsurable or is over 60 years of age, each VALIC individual deferred annuity policy includes life insurance (F.F. 33, R. 102). VALIC requires a minimum amount of life insurance in such cases, and offers additional insurance on various bases (F.F. 33, R. 102). An insurable individual holding an annual premium deferred annuity may, if he elects, provide for waiver of premiums to maturity in the event of total and permanent disability (F.F. 33, R. 103). As of May 31, 1957, VALIC had outstanding life insurance of $371,738 and disability premium waiver risk of $1,059,945 (F.F. 38, R. 106).[9]

(ii) Beneficiary settlement options.

Individual deferred annuity policies include beneficiary settlement options, counterparts of the types customarily offered by other life insurance companies, which permit direct settlement with beneficiaries without the necessity of going through estates (F.F. 33, R. 103).

2. Group and pension trust policies.

VALIC's three approved forms of group policies parallel group annuities offered by other life insur-

[9] The testimony of SEC's expert (R. 273-274) provides the complete answer to NASD's effort (Br. 12) to imply that there is some impropriety in the use of reinsurance by a young and growing life insurance company.

ance companies (SEC expert, R. 257-262).[10] The major portion of the annuity business in recent years has been in the group field (SEC expert, R. 257), and VALIC expects this to be true of its business (R. 507-508).

The three policies are the pension trust policy (P. Ex. 10, R. 208, 689), the deposit administration policy (P. Ex. 11, R. 209, 701), and the money or unit purchase policy (P. Ex. 12, R. 210, 713). All are described in P. Ex. 2, R. 126, 603-604. While they have different mechanical procedures and some differences of actuarial techniques, essentially they provide a choice of vehicles whereby an employer may provide an insured retirement program for his employees, with the employer's contribution as premiums and the employee's income at retirement having the benefit of the variable annuity principle.

These policies, especially the deposit administration policy, parallel the I. P. G. (Immediate Participation Guarantee Plan) policy, which for years has been issued by some of the largest life insurance companies (R. 539). Under the I. P. G. policy, the employer's premium, administered by the insurance company, is adjusted annually by the actual expenses and the actual investment experience of the insurance company, including capital gains and losses (R. 539, 560-561). The adjusted amount provides employee retirement benefits, subject to experience adjustments in the pay-out period (R. 539). SEC has never, so far as this record, SEC reports, or the SEC Briefs indicate,

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[10] VALIC notes the reference by NASD (Br. 69) to two bills introduced in Massachusetts which will authorize group variable annity policies. NASD states (Br. 68) that these bills do not relate to "insurance." The statement that group policies are not insurance will come as a shock to the insurance administrators and to the entire insurance industry.

claimed that the I. P. G. policy is a security, despite the variable payments directly dependent on investment results.

III

VALIC'S PRINTED DESCRIPTIVE MATERIAL.

All VALIC sales literature must conform to the standards set by the District/state insurance statutes and the insurance commissioners of the states where VALIC operates. As VALIC has built its business, the material naturally has evolved. SEC carefully avoids any quotations from the material relating to VALIC's current policies (D. Exs. 19, 22-27, R. 378, 745, 777-804).

An objective reading of all VALIC's sales literature, however, including P. Exs. 20 and 21 as background and 19 and 22 through 27 in use at the time of the trial, demonstrates that the basic objective of the variable annuity is retirement planning: "retirement financing" (R. 747), "retirement objectives" (R. 748), "retirement income" (R. 794, 801), "retirement purposes" (R. 757), and "retirement plan" payable for life (R. 748, 778, 782, 795). The available life annuity options and the impact upon them are fully and simply explained (R. 756, 781, 783-785). Nowhere in this material is there language indicative of security sales or an invitation to "speculation."

The trial court had no doubt as to the thrust of VALIC's activities:

> "Variable annuity policies have been designed and are intended as a means of providing a retirement program under which benefit payments tend to vary with cost of living charges" (*sic.*—Read "changes."—F.F. 29, R. 100).

This finding, not attacked, accurately epitomizes the emphasis of VALIC's sales material.

Of VALIC's sales literature, the Insurance Commissioner of the State of West Virginia very recently has stated officially:

> ". . . the defendant's operation and its sales literature have been reviewed by the Insurance Commissioner. The defendant has filed with the Insurance Commissioner all of its sales literature and other material used in West Virginia. The Insurance Commissioner has not found that this material misrepresents the terms of its policies, nor that it is deceptive nor that it constitutes an unfair trade practice as defined in Sections 3 and 4, article 11, chapter 33."[1]

Since the state insurance authorities have found that VALIC's printed descriptive materials are proper, SEC's contention that they are not proper (e.g., SEC Br. 31) illustrates the potential conflict between the two administrative authorities if SEC should succeed in this action.

There is no reasonable basis for any contention that any prospective purchaser of a VALIC deferred life annuity could have any uncertainty in his mind as to the fact that the policy provides for variable annuity payments. Each policy bears on its face in bold red type:

> "ANNUITY PAYMENTS PROVIDED BY THIS POLICY ARE VARIABLE AND ARE NOT GUARANTEED AS TO FIXED DOLLAR AMOUNT" (F.F. 35, R. 104).[2]

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[1] Brief (p. 15) of *Amicus Curiae* on behalf of C. Judson Pearson, Insurance Commissioner of the State of West Virginia, in *West Virginia ex rel. Sims, Commissioner of Securities* v. *VALIC*, pending in Circuit Court of Kanawha County, West Virginia, *supra*.

[2] Each annuity policy incorporates data from the individual's application with respect to age and sex, as well as annuity, life, and disability coverage desired. The processing of the application follows the normal routine of insurance companies (R. 504).

Each application for a policy recites in red ink immediately above the applicant's signature:

> "I understand that all dollar benefits, except any life or disability insurance benefits, provided under the policy being applied for will be variable and are subject to fluctuation by reason of the investment experience of the Company" (D. Ex. 24, R. 406, 835; see also D. Ex. 25, R. 406, 839.)

IV

TESTIMONY OF VALIC POLICYHOLDERS.

SEC called two VALIC policyholders as witnesses and then decided not to call as witnesses eight other policyholders whom it had under subpoena (R. 375). The testimony of the two policyholders who reached the witness stand was so destructive of the SEC case that SEC and NASD studiously ignore it.

The VALIC policyholders confirmed the long-range retirement, annuity income motivation of purchasers of VALIC policies. Their testimony covers only 14 pages (R. 360-374); and should be read in its entirety. It demonstrated:

1. The variable annuity was purchased as a part of an overall retirement plan (R. 361, 371).

2. The buyers understood that the contract had a total disability provision, a loan provision, and term life insurance but these "were only added enhance-

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Normally, therefore, the policy would not be completed in detail before the application is received.

Of the two policyholders called by SEC, one could not recall whether he saw his contract before he made his first premium payment (R. 366); and one stated that he did not receive the policy until "sometime after we made the application" (R. 361). From this testimony, the SEC inaccurately generalizes that "the evidence is that the purchasers did not see the contract until they had incurred the obligation" (SEC Br. 18). Of course, no policy imposes any "obligation" on the insured-annuitant.

ments to the main purpose of the contract which was for the retirement purpose" (R. 364).

3. It was understood that a portion of the premiums would accumulate to pay the annuity at the end of the contract.

4. It was understood that the purchaser had a choice of optional annuity periods, each being dependent on one or more life contingencies.

5. It was understood that the annuity benefits under the policies would vary.

6. It was understood that the annuity payments under the policy would tend to parallel changes in the cost of living, down or up.

7. It was understood that there was a risk that the amount of annuity payments would fluctuate and that the risk of such fluctuation would be borne by the policyholder.

8. A contract was desired which "would mitigate the technical obsolescence of the dollar" (Policyholder's description, R. 366).

In this connection, SEC (Br. 37) attempts to draw solace from the fact that one policyholder witness used the word "investment" (R. 362). The witness' answer shows that he was not using "investment" in a "securities" sense:

> "Well, in order to serve the purpose of completing our plans for a retirement program beyond what we had invested in life insurance, we had to make a choice as to where we would invest what money we had" (R. 362).

SUMMARY OF ARGUMENT

I

VALIC's sole business is the writing of "insurance appertaining to persons." The issue in this action is whether a variable life annuity policy falls within the "business of insurance" subject to the regulation of the state insurance authorities, or within the definition of a "security" subject to jurisdiction of SEC. The Congressional intent, manifest in the McCarran Act and the federal Securities Acts, bars dual regulation.

Insurance is a group activity dealing with "insurable risks": risks as to which (i) each insured is separately exposed, and (ii) the chance of loss is actuarially predictable.

In life insurance the only "insurable risk" is the contingency of life. Life annuities protect against the risk of longevity by pooling the contributions of the members of the group and scientifically liquidating the aggregate over the uncertain life spans of the participants.

All life insurance companies selling life annuity policies make investments in media permissible under state insurance statutes and state insurance regulation. All such investments involve some risk. This "investment risk" fails to meet the distinguishing tests of an "insurable risk," *supra.* In every mutual company, and in every stock company (subject to the cushion of stockholder capital and surplus), this "investment risk" falls on the policyholders.

For nearly half a century, life insurance companies have been conscious of, and concerned with, the necessity of providing in their policies a measure of protection which would tend to keep pace with the cost of living. At least as early as 1935, American life insurance companies were issuing policies which, in every conceptual essential, were variable life annuities.

The variable life annuity issued by VALIC and other life insurance companies under state insurance laws and state insurance supervision differs from the fixed-dollar life annuity only in that it affords a contractually precise method of adjusting reserves and annuity benefits to the company's investment experience. The variable life annuity is an insurance policy, and in offering it VALIC is engaged in the business of "insurance appertaining to persons."

II

The McCarran-Ferguson Insurance Regulation Act excludes the SEC from regulatory jurisdiction over VALIC. Prior to 1944 the states for 86 years had been active in the regulation of the business of insurance. The *South-Eastern Underwriters* case, 322 U. S. 533 declared the business of insurance to be interstate commerce. Shortly thereafter Congress passed the McCarran Act pursuant to its legislative judgment "that the continued regulation and taxation by the several states of the business of insurance is in the public interest."

The McCarran Act restored to the states, unless Congress should legislate specifically on the subject, priority in the regulation of the business of insurance. This regulation included state supervision of the organizational structure of the company, the types of insurance coverages it could offer, the form of such policies, including the method employed to determine, measure and express the amount of the insurer's liability, and the media of investments lawful for the insurance company's funds.

To impose on VALIC the regulatory scheme of the 1933 Act and the 1940 Act would supersede, impair, and invalidate state insurance laws under which VALIC is authorized to operate. As a conspicuous

example, provisions of the 1940 Act would make it legally impossible for VALIC to sell the very policies here involved, which have been approved, under District/state insurance law, by District/state insurance authorities.

The Life Insurance Act of the District of Columbia, administered through the Insurance Superintendent, affords the fullest protection to the public. Where a company, as does VALIC, operates outside the District, the states in which it is authorized to do business also regulate its activities.

III

VALIC does not sell "securities" within the purview of the 1933 Act. The variable life annuity policy is not a "security." It affords to the annuitant an income determined by his age and sex, and terminating on death.

The factor which distinguishes a life insurance annuity from a "security" is the group sharing of the risk of longevity. This essential distinction is not dependent upon an expression of minimum payments in fixed-dollar amounts, or upon the media in which the insurance company may elect, subject to the controlling insurance statutes, to invest. The distinction is clear and self-evident: those who die early receive income for a short time, and those who live long receive payments until death. No "security" has any such feature (SEC's "securities" experts, R. 306, 395, 404).

The 1933 Act exempts from registration "any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner . . . of any State or . . . the District of Columbia." VALIC's life annuity policies fall squarely within this provision, and the intent of Congress to exclude such insurance contracts from registration with SEC could not be more clearly expressed.

IV

VALIC is not an "investment company" within the purview of the 1940 Act. In addition to the requirement that an "investment company" be an issuer of "securities," legislative history demonstrates that Congress in 1940 was not seeking to impose dual regulation on insurance companies. Committee reports and Congressional debates confirm that it was the intent of the 1940 Act not to impose federal regulation on life insurance companies.

The Act specifically declares that, "notwithstanding" the sweeping language of its definitional section, an insurance company is not "an investment company within the meaning of" the Act (Sec. 3(c)(3).

VALIC is an "insurance company" as defined in and excluded from such Act: It is organized as an insurance company. Its sole—and clearly its "primary and predominant"—business activity is the writing of life insurance, disability, and variable annuity policies, all of which are integral parts of the business of insurance. It is subject to supervision by the District/state insurance commissioners in the District and in each state where it operates.

ARGUMENT

I

VALIC'S SOLE BUSINESS IS THE SALE OF "INSURANCE APPERTAINING TO PERSONS."

VALIC's sole charter authority is "to engage in the Life Insurance business, writing life insurance, disability insurance, and variable annuities in combination policies . . . written appertaining to persons as such business is now or may hereafter be regulated by the . . . 'Life Insurance Act' " (D. Ex. 3, 8, R. 406, 814, 817).

A. VALIC'S POLICIES EFFECTUATE THE TRADITIONAL FUNCTION OF THE BUSINESS OF LIFE INSURANCE

1. Concepts: "investment," "securities," "insurance."

This case involves three concepts which for clarity must be kept distinct: (a) "investment," as the savings program of the individual; (b) "insurance appertaining to persons"; and (c) "securities" as defined in the 1933, 1934 and 1940 Acts.

2. "Investment": The care of surplus funds.

In his savings plan, one "invests" by converting a portion of his transient income into some form of wealth other than money, with the intent that he, his family, beneficiaries, heirs, or estate will at some future date enjoy benefits which this investment will procure. The field of "investment" is as broad as the instrumentalities available for one's surplus funds. Initially one usually buys life insurance. Said SEC in 1940:

> "Life insurance provides the channel through which millions of American people accumulate savings to gain for themselves and their family a larger measure of security . . ."[3]

In 1957, 121,000,000 Americans owned $500 billion of such family "securities".[4] After life insurance came a home and then savings find a variety of outlets—whether in life insurance annuities, interest bearing deposits, government or corporate securities, works of art, or other available means for preserving value.

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[3] SEC Report, "Study of Legal Reserve Life Insurance Companies," TNEC MONOGRAPH 28, p. 1. This Report was prepared by SEC between July 7, 1938 and July 22, 1940, the date it was transmitted to the Temporary National Economic Committee by Sumner T. Pike, then an SEC Commissioner. It will be cited as "TNEC MON. 28."

[4] 1958 LIFE INSURANCE FACT BOOK, p. 7.

The issue here, therefore, is not "insurance" versus "investment" (cf. SEC Br. 3 fn). It is "insurance appertaining to persons", under the District and state insurance laws versus "security" as defined in the 1933 Act, the Securities and Exchange Act of 1934, and the 1940 Act.[5]

3. "Insurance appertaining to persons."

a. The nature of "insurable risk."

The essence of any insurance operation is the shifting and distribution of an "insurable risk." To be insurable, a risk must meet two conditions (R. 460):[6]

(i) It must involve a fortuitous hazard to which the insured individual is separately vulnerable, so that if the peril strikes, the impact falls on the individual and can be absorbed by the insurer and spread among the group of unscathed policyholders; and

(ii) It must be actuarially predictable, so that it can become the subject of scientific group distribution.

b. The function of insurance "appertaining to persons."

The insurable risk in life insurance is the uncertainty as to the time of death. Life insurance companies protect against the financial consequences of (i) death, and conversely, (ii) longevity (P. Ex. 22, R. 778; SEC expert, R. 219-220). Though actuaries can not foresee how long any individual will live, they can forecast, on the basis of statistical data accumulated in mortality tables, the average lifetimes of groups (R.

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[5] Congress has exercised care to define "security" in numerous other statutes: e.g. 16 U.S.C. § 796(16) (Federal Power Act); 11 U.S.C. § 402 (bankruptcy); 11 U.S.C. § 205(b) (railroad reorganizations); 11 U.S.C. § 506 (corporate reorganization); 18 U.S.C. § 2311 (crimes); etc.

[6] For these reasons an insurance company's "investment risk" is not an "insurable risk".

254-257, 456-457). Investment companies, of course, "don't use mortality tables at all" (SEC expert, R. 322).[7]

With life insurance, the risk insured arises from early death. Premiums are calculated to bring in an aggregate capital fund from all insured persons sufficient (after expenses) to provide for losses on early deaths, making allowance for investment earnings and for "mortality gains" from premiums paid by those who outlive their normal life expectancies.

With annuities, the risk insured arises from longevity (cf. SEC expert, R. 220). Premiums are calculated to bring in an aggregate capital fund sufficient (after expenses) to provide for losses on longevity, making allowance for investment earnings and for "mortality gains" from termination of annuity payments to those who die early (R. 458).[8]

Thus the distinguishing characteristic of contracts issued by life insurance companies is the shifting and distributing of mortality risks (R. 220, 478). The actuarial considerations which must control this type of risk shifting and distribution with the use of mortality tables are within the traditional function and technical competence of life insurance companies. The variable annuity, involving this risk shifting and distribution, is "purely an insurance operation" (R. 485).

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[7] In attempting to analyze VALIC's deferred annuity policy, SEC found it necessary to call a life insurance actuary—Hooker—since their "securities" experts frankly acknowledged that they were not competent to discuss the policy (R. 321).

[8] This case is concerned with the sale of life annuity policies to the public by a life insurance company. It is unnecessary to discuss NASD's reference (Br. 37) to marriage, partnership, and other arrangements, wholly irrelevant to the insurance concept, which are used by individuals dealing with their own affairs.

c. The "investment risk" in life insurance operations.

SEC's case rests on its notion that what SEC calls the "investment risk" falls on VALIC's policyholders in a manner or to an extent fundamentally different from the manner in which it falls on policyholders of other life insurance companies.

Life insurance contracts usually involve an "investment element" (SEC expert, R. 263).[9] In the deferred annuity, net premiums build up over the years an aggregate of assets for the payment of annuity benefits. Thus every life insurance company comes to have funds which, as an incident to its insurance function, it invests in media authorized by state insurance statutes. By its nature, every such investment involves risk.

In all life insurance companies, the risk of adverse investment results falls solely or predominantly on the policyholders. It falls solely on them in the mutual company (R. 470-471, 473; SEC expert, R. 298), for they are "both the insurers and the insured". *Hutchins Mutual Ins. Co.* v. *Hazen,* 70 App. D. C. 174, 105 F. 2d 53, 57 (1939). Through dividends, or lack of them, the policyholders benefit from favorable, and suffer from unfavorable, investment, mortality, and expense results (SEC expert, R. 225; R. 470). In a stock company, the risk falls upon the policyholder also, subject to the cushion supplied by the stockholders' capital and surplus (R. 472).[10]

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[9] KRUEGER AND WAGGONER, THE LIFE INSURANCE POLICY CONTRACT (1953 ed.) 194, quoted *United States* v. *Bess,* 357 U.S. 51, 58 (1958).

[10] In 1957 the $683,000,000 aggregate capital of United States stock life insurance companies was less than .004 of the $178,500,000,000 of their outstanding insurance. 1958 LIFE INSURANCE FACT BOOK, pp. 15, 62. The reference does not state separately the surplus attributable to stock companies.

Moreover, under severely adverse conditions, the nominal amount of premium affords no ceiling on the cost of life insurance. While premiums remain unchanged, the available surplus is reduced (R. 471), and if results continue to be adverse the non-forfeiture portions of the policy are reduced by subjecting them to a lien.'"[1]

In life insurance, therefore, protection against adverse investment results does not rest upon the nature of the contract. The indisputable fact is that no life insurance or life annuity policy can or does shift the "investment risk." That is not an "insurable risk," since adverse results cannot fall upon the individual policyholder and so cannot be shifted to and shared by other policyholders who otherwise would have escaped the impact of the risk (R. 460).[2] The policyholder's

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[1] During the 1930's 39 life insurance companies discontinued operations with losses to policyholders (TNEC Mon. 28, p. 101-102). Nineteen discontinuances resulted in a total indicated initial loss to policyholders of over $138,000,000 (id. pp. 131-32). Liens in this amount, aggregating 57.4 per cent of net reserves on the policies, ranged from 50 per cent of net reserves in 9 companies to 100 per cent in 4 companies (ibid).

NASD Br. p. 37, fn. 1, extols what it calls the "common knowledge" of the liquidity of life insurance during these years, when (NASD claims) it paid all losses, cash values and loan values. Such "common knowledge" fades before the facts in TNEC Mon. 28.

[2] Among numerous errors in the SEC Brief is the statement (SEC Br. 35) that VALIC's "expert testified, the variable annuity cannot insure against this investment risk." The witness gave no such testimony. The source cited by SEC, R. 460, is correctly stated in the VALIC text above.

NASD raises the spectre of economic collapse so catastrophic that between the first monthly annuity payment and the second, VALIC's assets would be reduced to zero. Only that contingency could support NASD's statement, repeated four times in one paragraph (NASD Br. 9-10), that VALIC's contractual obligation

assurance rests primarily on three factors, none of which would be strengthened by superimposing the regulation of SEC:

i. The state statutes which, in every jurisdiction, fix the tests of investments deemed by the legislative body to be suitable for life insurance companies.

There is no restriction on the investments of any other District life insurance company which is not equally applicable to VALIC.[3] VALIC can invest only in media satisfying the requirements established by Congress in L.I.A. § 35-535 (F.F. 39, R. 106).[4] One class of investment authorized is the common stock of a company which has paid cash dividends on such common stock for the five years preceding purchase, provided that: (a) if the company has outstanding bonds or other evidences of indebtedness, interest must have been earned 1½ times for the last fiscal year and

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to an annuitant does not obligate it to make any payment after the first.

Contrast the testimony of SEC's expert that, assuming VALIC's solvency under the regulation of the District Insurance Superintendent, its policies provide the annuitants an income for life (R. 281-2).

[3] SEC's argument that it should regulate VALIC because SEC thinks that "the chance of spectacular success through speculative investment might sometimes outweigh considerations of safety" (SEC Br. 51) should be contrasted with its criticism of VALIC for the conservative investment policy the company was following at the time of trial (SEC Br. 18 fn). If SEC's argument had any merit, it would provide a lever for SEC to regulate all life insurance companies.

[4] The quality and diversification of an insurer's investments required by L.I.A. § 35-535, *supra*, may be compared with SEC Br. 28 reference to the provisions of the 1940 Act that "management" of the investment trust adopt a "fundamental investment policy" which can be changed only by "vote of its security holders." Query: does this afford protection comparable to a fundamental investment policy set, and changeable only by, Congress?

averaged 1½ times yearly for the preceding five years; (b) if it has outstanding preferred stock, preferred dividends must have been earned three times over during each of the three preceding fiscal years; and (c) not over 1 percent of the life insurer's admitted assets may be invested in the common stock of any one corporation.

ii. The ability and the integrity of the management.

No claim is or can be made on this record that the management and advisors of VALIC are not fully qualified, by experience, training and integrity, to operate the company in the interest of its policyholders.

iii. The constant, continuous, detailed supervision of the insurance superintendent and his staff.

The pervasive scope of this supervision goes so far beyond that of SEC in the "security" field that it sustains the comment that

> "the business of insurance has been more generally regulated than any other sphere of business activity not a public utility." *American Hospital & Life Ins. Co.* v. *F.T.C.*, 243 F. 2d 719 (5th Cir. 1957), aff'd per curiam, *Federal Trade Commission* v. *National Casualty Co.*, 357 U.S. 560 (1958).

B. VALIC'S POLICIES INCORPORATE PROTECTIONS WHICH EMBODY STUDIES AND PLANS OF THE LIFE INSURANCE INDUSTRY SPANNING FOUR DECADES

Congress did not petrify the insurance business when it enacted the 1933 Act. District and state insurance laws then required, and still require, that new policy forms be approved by the insurance authorities before they may be offered. Aside from statutory clauses, there are no standard forms. Insurers design and seek approval of contracts offering new forms of insurance service and protection as needs therefor are discerned (SEC expert, R. 227. Conceded, NASD Br. 39). As NASD says (Br. 38): "What a state, in the exercise

of its sovereign power, may choose to encompass within a statutory definition of the term 'insurance' need not be confined to the 'commonly accepted sense' of the term."

> "It has been estimated that more than half of all life insurance in force today represents uses of insurance protection which have either been introduced or received their major development in the past 25 years. Included are the family income plans, . . . retirement income insurance . . ."[5]

For at least forty years the life insurance industry has been conscious of the necessity of developing insurance techniques designed—in the words of one VALIC policyholder—to mitigate the "technical obsolescence" (R. 366) of fixed-dollar annuities.[6] To

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[5] 1956 LIFE INSURANCE FACT BOOK, Ct. Ex. 1, p. 12. Writing in 1958, Huebner found it necessary to make a "thorough revision" of his 1950 edition. "Recent years have seen tremendous changes in the life insurance business." HUEBNER and BLACK LIFE INSURANCE (5th ed. 1958), p. vii.

[6] In terms of a retirement policy covering 30 years of premiums, the real value (i.e., the purchasing power) of fixed-dollar annuities has suffered ruinous erosion (R. 412-4, 482; D. Ex. 30, R. 406, 841):

Inception Date	Inception Goal in Purchasing Power	Maturity Date	Maturity Purchasing Power
1880	$100.00	1910	$80.40
1890	100.00	1920	38.40
1900	100.00	1930	47.40
1910	100.00	1940	67.70
1920	100.00	1950	83.50
1930	100.00	1960	(?).
1940	100.00	1970	(?)

(Source: Bureau of Labor Statistics Cost of Living Index of all items for moderate income families in large cities D. Ex. 30, R. 841).

accomplish this, it was necessary to develop a means of expressing the company's policy liability in a measure keyed to the media available for investment of the company's assets.[7]

The problem was emerging before World War I.[8] But the ensuing years brought it into focus. In Germany before the drastic currency reforms of 1924, life insurance companies, trying to stabilize the insured's protection, issued policies payable in American dollars, rye and coal.[9] Use of these commodities as "policy money" was feasible because there were available at the time in Germany government bonds and debentures expressed in rye and coal.[10]

At the International Congress of Actuaries in London in 1927, attention was given to the problem (R. 481). Thirteen speakers, from ten countries, delivered papers upon the general subject of "currency depreciation as affecting life assurance contracts."[11] One important paper pointed out that an insurance company offering only protection in dollars or pounds can stand financially indifferent to inflation.

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[7] See Sir Joseph Burn, Address by the President, 8th International Congress of Actuaries, 59 JOUR. INST. ACTUARIES (London, 1928), Pt. 1, p. 19; Recknell, Insurance Against Inflation, TRAN. FACULTY OF ACTUARIES (1949) Vol. 19, Pt. 1, p. 23.

[8] Westergaard, Currency Depreciation as Affecting Life Assurance Contracts, TRANS. 8th INTERNATIONAL CONGRESS OF ACTUARIES (1927) Vol. II, p. 255, 259.

[9] Westergaard, *supra*. See also Recknell, *supra*. In Austria, policies also were expressed in United States dollars or in gold. Wollner, The Effect of Currency Depreciation . . . in . . . Austria, TRANS. 8th INTERNATIONAL CONGRESS, *supra*, p. 247.

[10] Gold, Inflation and Life Insurance, TRAN. SOC. OF ACTUARIES (1957) Vol. VIII, p. 315, 322.

[11] TRANS. 8th INTERNATIONAL CONGRESS OF ACTUARIES (1927) VOL. II, pp. 247-307.

"But . . . it is not indifferent to the policyholder, when his claim is due, to receive only a fraction of the purchasing power which he intended to acquire. . . .

"So long as money has a varying purchasing power there is thus . . . a vast field for progress in life assurance. . . . So far as I can see, the problem of stabilizing the sums assured [in terms of purchasing power] is the most important problem with which modern life assurance has to deal, and there is a vast field for real progress."[2]

In the early 1930's, with purchases of individual life annuities at a high level, American life insurance companies encountered two problems: mortality tables which did not reflect accurately the increasing longevity of annuitants; and unfavorable investment results due to declining returns on their investments.[3] Through cooperative studies, new mortality tables were developed to adjust for increased longevity. Of the investment rate, SEC said in 1940:

"A special problem was posed in the determination of the proper interest assumption for the annual premium retirement annuity involving as it did the investment (*sic*) of small sums over a long period of time as in the case of the life insurance contract. In an effort to solve the difficulties, more conservative interest assumptions were adopted."[4]

Then comes the emergence of all elements of the variable annuity. Reported SEC:

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[2] Westergaard, *supra*. See also Burns, *supra*. The same fact was expressed in Raynes, The Place of Ordinary Stocks . . . in the Investment of Life Assurance Funds, JOUR. INSTITUTE OF ACTUARIES (1928) Vol. 59. Pt. 1, p. 21.

[3] TNEC Mon. 28, p. 332.

[4] Ibid.

"Some companies substituted participating retirement annuities for the nonparticipating contracts which had been based on higher guaranteed rates and, in a few instances, the nonparticipating single premium immediate annuities were replaced by similar contracts on a participating basis. . . . [A] . . . but a few companies—including the two largest in point of individual annuity business, the New York Life and the Equitable of New York—adopted the participating forms."[5]

These contracts, put into effect January 1, 1935,[6] manifestly were variable annuities (though not until later was the term in common use). As the SEC expert explained, a "participating policy is a policy which, according to its terms, shares in the [di]visible surplus by the company" (R. 284). Both the companies and the SEC recognized that premiums and annuity payments would vary. The assumed investment return was sufficiently low to eliminate any reasonable possibility that the company's results could fail to exceed it,[7] and participation was substituted to permit the annuitant to share in dividends reflecting investment experience, mortality gains, and expense savings (SEC expert, R. 284):[8] in the premium payment period by using dividends to reduce the premium or to increase the accumulated cash value for the annu-

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[5] TNEC Mon. 28, p. 332.

[6] Id. p. 333

[7] Some companies selling fixed-dollar annuities today base their minimum obligations on a 2 per cent investment rate (R. 497). In the 43 years 1915-1957 inclusive, the investment income rate of United States life insurance companies has never been below 2.88 per cent (1947), has been below 3 per cent in only three years. 1958 LIFE INSURANCE FACT BOOK, p. 59.

[8] The "dividend" on such a participating annuity policy "is relative to problematical earnings and not absolute to the payment of fixed sums." *Herman* v. *Mutual Life Ins. Co.*, 108 F. 2d 678, 681 (3d Cir. 1939).

ity; in the annuity payment period by adding dividends to the minimum payments. The policyholder under such a contract shares in the investment results of the company in the same manner that the owner of the variable annuity does (R. 473).

> "Under participating annuity policy contracts, the amount of the payment to the annuitant may vary . . . arising from experience more favorable than anticipated. . . . Plaintiff SEC does not contend, neither has it shown, that it has ever instituted any legal or administrative action charging that annuity policies payable in fixed-dollar amounts issued on a participating basis are 'securities' . . . , or that the insurance companies issuing such policies are 'investment companies' under the . . . Act of 1940" (F.F. 28, R. 100).

It soon was obvious, however, that this embryonic form of variable annuity based on participating policies could not keep pace with changes in the cost of living.

The next essential step was a broader statutory classification of investments legal for life insurance funds. Again SEC lent its prestige. In what SEC itself described as "in many respects the most significant section,"[9] its TNEC report criticized life insurance investment practices and summoned the insurance companies "to find methods by which the funds flowing under their control will become available as equity . . . and by which investments in common stocks will become more prevalent."[10]

This Report stimulated wide public discussion, followed in 1941 by publication of "Statement on Life Insurance," TNEC Monograph 28-A. This mono-

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[9] TNEC Mon. 28, p. 3.

[10] Id. at p. 378.

graph published the comments of certain insurance companies, and the "Rejoinder" of SEC Commissioner Pike and his senior staff assistant. Two aspects of this Rejoinder are significant in the context of this litigation.

First, it emphasized:

> ". . . The recommendations on the common stock question were contained in suggestions for State legislation and it was specifically pointed out that the recommendations in no way directly or indirectly, were intended to suggest that the Federal Government exercise authority over the investments of life insurance companies."[1]

Secondly, the Commissioner transmitted for the record a copy of a 1939 address by Dwight C. Rose, president of the Investment Counsel Association of America, made to the American Life Convention, entitled "The Policyholders' Interest in Equity Investments."[2]

Rose's address, printed in full in TNEC Monograph 28-A, urged a wider use of common stocks as outlets for life insurance funds. He warned, however, that "From the policyholder's standpoint . . . the inclusion of a small equity participation in life insurance reserve funds, against the regular 'dollar' policies now issued, would do little toward solving the basic problem of 'purchasing power' protection."[3] He therefore proposed that life insurance companies issue "equity policies" under which the:

> "dollar value of premium, face amount, or cash surrender, would of course vary from time to time

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[1] TNEC Mon. 28-A, p. 25.

[2] Id. at p. 26.

[3] Id. at p. 53.

with the changing dollar value of the equity fund.'"[4]

During the 1940's state statutes governing the investments of life insurance companies were amended so as to increase the eligibility of common stocks. Today in over two-thirds of the states, statutes specifically authorize investments by life insurance companies in common stock within differing limits. At the close of 1957 United States life insurance companies owned some 1.87 billion of common stocks.[5] Subject to the supervision of the respective state insurance authorities, at least seven states and the District of Columbia do not limit, by percentage or other formula, the amount which domestic life insurance companies may invest in common stocks meeting prescribed statutory standards.[6]

All the elements were now available to permit the life insurance companies to bring to fruition the trend which had been initiated three decades before.

The "economic premise" of variable annuities "is derived from historical studies relating to substantial long-term correlation in the movement of (i) average market prices of a selection of common stocks, and (ii) cost of living indices" (F.F. 29, R. 100).[7] After

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[4] Ibid.

[5] 1958 LIFE INS. FACT BOOK, p. 91. In addition, the companies held 1.5 billion in preferred stocks.

The Wall Street Journal, December 16, 1958, p. 23, reported that in the first 49 weeks of 1958, 33 major life insurance companies invested $152,467,234 in common stocks.

[6] Arizona, Arkansas, Connecticut, District of Columbia, Georgia, Louisiana, New Hampshire, and New Jersey. The District standards for common stock investments (L.I.A. § 35-535) are stated at p. *supra*.

[7] The validity of this premise has been confirmed by the Prudential Insurance Company in tests of hundreds of historical

twenty-odd years of discussion, actuaries were saying that "The time has come for us seriously to consider the possibility of devising some means of mitigating for our policyholders the evil results of fluctuations in the purchasing power of the eventual proceeds of their policies."[8] In 1950 Teachers Insurance and Annuity Association ("TIAA"), a legal reserve life insurance company selling annuities to college staff members, made exhaustive economic, actuarial, and legal studies which established the soundness of variable annuities as an instrument of retirement planning (R. 483).

College Retirement Equities Fund ("CREF"), a companion company under joint management with TIAA, was incorporated in 1952 by Laws—New York 1952, c. 124, which subjected it to regulatory provisions of the New York Insurance Law.[9] Under the supervision of the New York state insurance authorities, CREF offers to educational personnel variable annuities supported by reserves invested in equities, with benefits reported in terms of accumulation units and annuity units. At the end of 1956, CREF variable annuities covered 31,156 individuals; its net assets were $39,817,951; and its annuity unit, which in July, 1952, was attributed a dollar valuation of $10, had a valuation of $18.51 (D. Ex. 36, R. 847). Maclean, one

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situations (R. 415). The results are shown graphically in D. Exs. 31, 32, 33, and 34, R. 424, 426, 427, 429, 842-845. They are explained in detail by Prudential's Director of Economic and Investment Research at R. 418-433.

[8] Recknell, Insurance Against Inflation, TRAN. FACULTY OF ACTUARIES (1949) Vol. XIX, Pt. 1, p. 17.

[9] Among other things, CREF's constitution and by-laws, its forms of contracts, and its rules for determining annuity benefits must be approved by the Superintendent of Insurance of New York. CREF reports annually to the Superintendent of Insurance of New York. It is "effectually within the control of the Superintendent" (R. 485).

of the outstanding authorities on life insurance, and a trustee of TIAA who was directly concerned with the development of CREF, characterized CREF as "the best example of a pure insurance arrangement that you can have . . . [I]t is purely an insurance operation" (R. 480, 485).[10]

Continued study during the 1950's of means of bringing the protections afforded by life insurance and life annuities into closer harmony with changes in the cost of living is reflected in reports of numerous addresses and conferences at meetings of representatives of life insurance companies.[1]

Meantime, of course, CREF had shown the practical route to a broader base of insurance protection. With the CREF example in mind, life insurance companies were organized with authority to offer variable life annuities. The first life insurance company to offer variable annuities to the general public was Participating Annuity Life Insurance Company, formed by professors associated with the University of Arkansas, which has been selling variable life annuity policies under the supervision of the insurance authorities of Arkansas—and without attack from SEC—since 1954. VALIC followed in 1955 and EALIC in 1956.[2]

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[10] Characteristic of its approach, NASD asserts flatly that CREF is one of "pension plans, which are not insurance" (Br. 68-9).

[1] See TRANSACTIONS, 14th INTERNATIONAL CONGRESS ACTUARIES, Vol. II for numerous papers dealing with the effect of inflation on life insurance. See also: Gold, Inflation and Life Insurance (1956 Annual Meeting) TRANS. SOC. ACTUARIES, Vol. VIII, p. 315; Insurance Contracts in Terms of Equity Shares, Session Nov. 25, 1957, JOUR. OF INST. OF ACTUARIES, Vol. 84, pt. 1, p. 37 (1958); Junnilo, The Methods Taken by Finnish Life Assurance Companies to Protect Life Assurance Against Inflation (Helsinki, 1958).

[2] NASD's statement (Br. 5) that VALIC and EALIC were "first" is factually incorrect.

Variable annuities, as a part of the state's retirement program for teachers and certain municipal and state employees, were provided by Wisconsin Laws 1957, chs. 322, 381, and 423, which put into effect a report and recommendations of the Governor's Retirement Study Commission.

Within the past several weeks there has been filed with SEC a registration statement covering $7,500,000 of common stock of the Government Employees Variable Annuity Life Insurance Company, a life insurance company chartered under District law, which has announced that it will offer variable annuity policies.

From the post-World War I policies issued in terms of coal and rye, through the increasing recognition of index-clauses and the stabilizing effect of equity investments, to the carefully considered development of the variable annuity, runs a steady evolutionary development in the life insurance technique. No one suggests, least of all VALIC, that the variable annuity is the final answer: it submits, however, that it is the best thus far evolved from nearly half a century of study within the life insurance industry.

II

THE McCARRAN-FERGUSON INSURANCE REGULATION ACT EXCLUDES THE SEC FROM REGULATORY JURISDICTION OVER VALIC

The McCarran Act declares "that the continued regulation and taxation by the several States of the business of insurance is in the public interest." McCarran Act preamble, 15 U.S.C. § 1011.[3] The trial court and the Court of Appeals correctly held that the regulation of VALIC's business and its contracts is vested in the District and the State insurance authorities.

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[3] The McCarran Act, § 5, includes the District of Columbia in its definition of "State".

A. BACKGROUND OF THE McCARRAN ACT

Following *Paul* v. *Virginia*, 75 U.S. (8 Wall.) 168 (1868), the insurance business until 1944 was held not to be "commerce";[1] Congress did not attempt to regulate it; and the states developed comprehensive regulatory and taxing systems. *Prudential Ins. Co.* v. *Benjamin*, 328 U.S 408, 415-417 (1946). Under their police power, the states have ample power to protect from fraud, incompetence, misrepresentation, and sharp practice in the business of insurance. *Robertson* v. *California*, 328 U.S. 440 (1946); *Travelers Health Ass'n.* v. *Virginia, ex rel. State Corporation Commission*, 339 U.S. 643 (1950). Of State regulation, Mr. Justice Jackson stated (322 U.S. at 590):

> "Such state departments, through trial and error, have accumulated that body of institutional experience and wisdom so indispensable to good administration."

United States v. *South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), declared the business of insurance conducted across state lines to be interstate commerce. The decision raised serious questions: one dissent stated that it would require "a generation of litigation" to define the respective areas of federal and state regulation.[2] Federal regulatory statutes of general application had not been drafted with the thought or intent that they should be applied to insurance. Their attempted application would have induced dislocations and conflicts.

This is illustrated by the present action. The potential confusions, if both State insurance commissioners

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[1] See for example, *New York Life Ins. Co.* v. *Deer Lodge County*, 231 U.S. 495 (1913); *Hooper* v. *California*, 155 U.S. 648 (1895). Other cases are cited in *United States* v. *South-Eastern Underwriters Ass'n, supra*, 322 U.S. 544, n. 18.

[2] 322 U.S. at 590.

and SEC undertake supervision of VALIC's business and policies, have been understated: "It is probable" —VALIC would say it is certain—"that in the regulation of the business of insurance by both the federal and state governments there will develop a conflict of policies . . . [I]n such event the federal regulation would control. If so, 'the continued regulation and taxation by the several states,' referred to in . . . the [McCarran] Act as being in the public interest, would no longer exist." *National Casualty Co.* v. *FTC, supra,* 245 F. 2d at 883, aff'd *Federal Trade Commission* v. *National Casualty Co.,* 357 U.S. 560 (1958).

An SEC expert, a former commissioner of the SEC, declared that if a variable life annuity policy were held to be a "security" under the 1933 Act, "it is possible" that "if the variable annuity is issued by an insurance company acting in pursuance of the regulations of an insurance commission of a state, that immediately upon its issuance it would become in conflict between state and federal laws" (R. 402).

The effort of SEC to strain VALIC into the "investment company" category illustrates this conflict. SEC contends that VALIC is a management company under § 4 (3) of the 1940 Act.[6] The Act divides "management companies" into "open-end" and "closed-end" companies, id. § 5(a).[7]

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[6] SEC has never contended that VALIC is a "face-amount certificate company" (1940 Act, § 4(1)). Count Three of the SEC Complaint may have been intended to charge that VALIC is a "unit investment trust" (id. § 4(2)), but that Count has been explicitly abandoned (SEC Ct. App. Br. 3, fn. 3).

[7] Congress' intent to fix, and limit, the possible classification of "management companies" is unquestionable. Congress deleted from S.B. 3580 a section (§5(d)) which would have granted SEC authority "to make further classifications and subclassifications of investment companies."

Accept SEC's contentions and it follows:

1. If VALIC were an open-end investment company it would be unlawful for it to "issue any class of senior security." 1940 Act, § 18(f). VALIC's variable annuity policies constitute a claim on all its assets senior to the rights of VALIC's stockholders (SEC expert, R. 296): if they were "senior securities" they would be flatly prohibited.

2. If VALIC were a closed-end investment company it would be unlawful for it to issue a "senior security representing indebtedness" unless it had an asset coverage of 300 per cent; or a senior "stock" unless it had coverage of 200 per cent. 1940 Act, § 18(a)(1)(A) and (2) (A). Such asset coverages on insurance policies would be utterly impossible.

SEC does not say which section it would seek to apply, but either alternative would bar VALIC from offering the very policies which the Insurance Superintendent has approved.

The destruction of VALIC which would follow from these statutory provisions was pointed out in both courts below. SEC in the Court of Appeals conceded that "if the injunction were granted on this ground [i.e., 1940 Act, § 7(a)] it would effectively prevent the appellees from engaging in any of the activities alleged in the complaint" (SEC Ct. App. Br. 3, fn. 3). In this Court, SEC is somewhat less frank. It seems to suggest that VALIC might survive,

> "even though the respondents would have to alter their structure and the provisions of their present contracts to comply with some of the Act's provisions" (SEC Br. 54).

But by these cryptic words SEC admits that its claims here, if upheld, would invalidate, impair and supersede the insurance laws of the District and the states under which VALIC operates.

What SEC means by the language "alter their structure" may be clarified by a letter of SEC, dated December 24, 1958, with respect to the prospectus for an underwriting of stock for another variable annuity life insurance company referred to p. 49, *supra*. SEC, with respect to the present appeal pending in this Court, states:

> ". . . should the Court uphold the contention that these Acts are applicable to companies issuing variable annuity contracts, the registrant would be an unregistered investment company and all sales and contracts previously made by the company would be in violation of the Acts and therefore void . . . If liquidation of the registrant would be a possible result of such decision, this should be made clear, including a discussion of the liquidation rights of the stockholders."

(Source: Government Employees Variable Annuity Life Insurance Company, SEC File No. 2-14535, letter by Charles H. Eisenhart, Assistant Director, Division of Corporation Finance, December 24, 1958, pages 1, 6).

SEC thus would seem to fully substantiate VALIC's contention that if VALIC were subjected to the 1940 Act, its policies would be invalidated and its entire business destroyed. This would not be regulation but sheer annihilation. Surely the Congress, which enacted the L.I.A., the 1940 Act and the McCarran Act never contemplated or envisioned such a catastrophic result.

B. PURPOSE OF THE McCARRAN ACT

In the first session of the 78th Congress, in 1943, S. 1362, H. 3269, and H. 3270 were introduced prior to, but in anticipation of, *South-Eastern Underwriters, supra.* These bills contained one paragraph to exclude the business of insurance only from the Sherman and Clayton Acts. The narrow scope of these early bills lends added significance to the broad and carefully integrated provisions of the final Act, and provides a conclusive rebuttal to SEC's argument (Br. 57) that in this Act the purpose of Congress was "limited [to] the suspension [of] the class of regulation which had thrown the insurance companies into confusion", i.e., "the antitrust laws" (SEC Br. 15).

Congress intended by the McCarran Act:

> ". . . broadly to give support to the existing and future state systems for regulating and taxing the business of insurance . . .
>
> ". . . Congress must have had full knowledge of the nation-wide existence of state systems of regulation and taxation; of the fact that they differ greatly in the scope and character of the regulations imposed and of the taxes enacted; and of the further fact that many, if not all, include features, which to some extent, have not been applied generally to other interstate business. . . . [Its] purpose was evidently to throw the whole weight of its power behind the state systems, notwithstanding these variations." *Prudential Ins. Co.* v. *Benjamin, supra,* 328 U.S. 430.

See also *Wilburn Boat Co.* v. *Fireman's Fund Insurance,* 348 U.S. 310 (1955); *Maryland Casualty Co.* v. *Cushing,* 347 U.S. 409 (1954); *North Little Rock Transportation Co.* v. *Casualty Reciprocal Ex-*

change, 181 F. 2d 174 (8th Cir. 1950), cert. denied 340 U.S. 823 (1950).

Congress did have knowledge of the local variations in state systems of regulation and taxation. It rejected a Department of Justice recommendation "that the Federal Government should interfere with State regulation where the latter is not adequate according to a standard determined by the Department of Justice" (H. Rep. 873, 78th Cong., 1st Sess., Nov. 18, 1943, p. 7). That suggestion was prophetic of SEC's present theme, that its jurisdiction should be expanded because SEC thinks that its supervision of VALIC is "needed." The Report stated:

> ". . . The committee is not impressed by such argument. If the States are to be permitted to regulate, they should be permitted to regulate as they see fit. The Committee believe that in considering the nature of the business of insurance, its closeness to policyholders in the several States, the established systems of regulation and control by the States, and the experience and attitude of State insurance Commissioners, regulation by the States should not be circumscribed by the establishment of any control over their power of regulation or the exercise by them of that power."[8]

The McCarran Act and similar legislation was under consideration by Congress for two years. Its language evidences the most precise draftsmanship. It specifies the areas in which federal power under general regulatory statutes is preserved: the Sherman Act remains applicable to all agreements to boycott, coerce, or intimidate (§ 3(b)); the Sherman Act (in other re-

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[8] As Senator Ferguson remarked: ". . . we believe that all the wisdom is not here in Congress. We believe that there is some wisdom left in the legislatures of the various states, and that they should exercise their judgment and regulate insurance . . ." (91 Cong. Rec. 1481).

spects) and the Clayton and the Federal Trade Commission Acts remain applicable (since June 30, 1948) to the extent the business of insurance is not regulated by state law (§ 2(b)) the National Labor Relations Act, the Fair Labor Standards Act of 1938, and the Merchant Marine Act of 1920 remain fully applicable (§ 4). Neither the 1933 Act nor the 1940 Act were placed in the category reserved to federal control.

In the 80th Congress, shortly after the McCarran Act, five bills were introduced to assure that District Insurance Laws satisfied the McCarran Act. One of these, after careful legislative consideration, became the Act of May 20, 1948, 62 Stat. 242.

The *Hearings Before Subcommittee On . . . Insurance of the Committee on the District of Columbia, House of Representatives,* 80th Cong., 1st Sess., May 7, 1947, show Congress' intent to invest in the Insurance Superintendent full responsibility for insurance regulation, leaving no gaps for federal agencies to occupy.

Before the Subcommittee of the Senate Committee on the District of Columbia, Senator Cain observed to the Insurance Superintendent (Mr. Jordan):

> "I daresay that you have the authority, in your general powers, to examine any new insurance situation that comes up, and either take action on the situation or recommend legislation to accommodate its needs" (*Steno. Tr. Hearing March 8, 1948,* p. 13).

When a situation arises which in his judgment calls for Congressional action, the Insurance Superintendent recommends legislation, e.g., Public Law 85-334 (72 Stat. 19), approved February 22, 1958. This Act made significant changes in the insurance laws of the District. It gave the Insurance Superintendent added regulatory powers in the public interest: for example,

he may refuse to issue or renew a certificate of authority or license if the issuance or renewal "would adversely affect the public interest" (Sec. 5). This statute, though passed months after the widely publicized trial of this action, made no change in the law under which VALIC is incorporated and carries on its business of insurance. The 1958 amendment, however, afforded SEC the opportunity, as the trial court suggested, to make its arguments "to the Congress" (Opinion, R. 91). SEC apparently found that prospect unattractive. Clearly Congress found no need to add legislation relative to the variable annuity.

In the McCarran Act, we have an unambiguous statute in a coherent scheme of regulation. The Acts of 1933 and 1940 exclude from SEC jurisdiction insurance companies and the contracts issued by such companies under the supervision of State insurance authorities (See Points III and IV below). The McCarran Act broadly declares (subject to specific exceptions not here applicable) the policy of State insurance regulation.

The most recent efforts of a federal agency to regulate insurance companies were by the Federal Trade Commission. This Court rejected the Commission's claim to superimpose federal upon state regulation. *F.T.C.* v. *National Casualty Co., et al.,* 357 U.S. 560 (June 30, 1958).

C. INSURANCE REGULATORY STATUTES AND INSURANCE ADMINISTRATIVE DEPARTMENTS FULLY PROTECT THE PUBLIC INTEREST

The SEC brief, if read by one unfamiliar with the administrative agencies of this nation, would create the impression that VALIC is subject to no regulation. On the contrary, as stated by one witness, insur-

ance companies "are already subject to so rigid a supervision that the interest of the public and of our policyholders is adequately protected" (R. 434).

The regulation of life insurance through state officials is in its 100th year. Regulation of the life insurance industry is effectuated through legislation,[9] administrative agencies, and judicial interpretations. Uniformity is promoted through the National Association of Insurance Commissioners (R. 501).[10] Official regulation is supplemented, by codes of ethics and similar self-regulatory forces, through twenty-odd trade organizations.[1]

In the District of Columbia, Title 35 of the Code (1951) sets forth the basic insurance law in 253 sections covering some 100 pages. Chapters 3-8 are "The Life Insurance Act." These statutes (not mentioning the extensive regulation in six other states)[2] dispel

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[9] The citations to the insurance codes of the States and territories and regulation of annuities by the state insurance commissioners are set forth in Appendix I, pp. 1a-5a, *infra*.

[10] The state commissioners are listed in 1958 LIFE INSURANCE FACT BOOK, p. 112.

SEC incorrectly states (Br. p. 43) that in some states securities commissioners have jurisdiction over insurance. In no state does the operation of insurance companies come within the jurisdiction of a securities commissioner. What SEC probably means is that in some jurisdictions the same individual holds both the office of insurance superintendent and that of securities administrator (Florida, Hawaii, Montana, South Dakota, and Vermont), and that in three states, regulation of "securities" is handled by the local insurance commissioner (Iowa, New Hampshire, and South Carolina).

[1] Listed, id. at p. 113.

[2] Life insurance companies are subject to multiple State regulation, i.e., the laws of each State in which insurance contracts are sold are applicable. Thus, "convention" examinations of life insurance companies are made by examiners representing a group of State insurance departments, including the department having jurisdiction of a domestic insurance company (R. 512). VALIC

any anxiety which SEC pretends for VALIC policyholders. The SEC "does not argue that [these] statutory provisions were mere pretense." *F.T.C.* v. *National Casualty Co.*, 357 U.S. 560, 564 (1957). VALIC operates under affirmative authority evidencing the insurance authorities' application of the insurance statutes to this individual case. Rather, SEC merely ignores the District/state insurance regulation.

We summarize the District statutes:

The Insurance Superintendent is vested with supervision of all matter pertaining to insurance and insurance companies, subject only to the general supervision of the Commissioners (L.I.A. § 35-101). His office is public, and records, books and papers on file are public records (L.I.A. § 35-401).

Disclosure requirements. Nothing in SEC practice approaches the disclosure required by the Life Insurance Act. Certain of its provisions are printed in full as App. VI, p. 10a-14a.

The Life Insurance Act requires the filing of annual financial and statistical reports with the Insurance Superintendent, and publication of a summary financial report in a District newspaper (L.I.A. § 35-103, 35-407). VALIC's annual report to the Superintendent is on the standard form (L.I.A. § 35-406, 407; § 47-1802) recommended by the National Association of Insurance Commissioners. (P. Ex. 5, R. 186, 653) This report, 42 pages each 12" × 19", is "designed to ferret out every fact which the [NAIC] committees, over the years, have deemed significant," and is on file and available for inspection by any interested party in any

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also is subject to examination at the discretion of any insurance commissioner of any state in which it is authorized to do business. E. g., West Virginia Code (1955) § 3296; Arkansas (1957 replacement) § 66-115; Kentucky Rev. Stat. (1955 ed.) § 304.030; Alabama § 51, Title 28; New Mexico § 58-S-13.

State where VALIC operates (SEC expert, R. 268).

The Superintendent submits to Congress annually a printed report on each insurance company subject to his jurisdiction, which report is a public document (L.I.A. § 35-106, 35-107).

The Insurance Superintendent may examine the company at any time, and must examine it once each three years; and these examinations may include, at his discretion, interrogation of every person having knowledge of the company (L.I.A. § 35-418).[3] The subpoena power (L.I.A. § 35-412) is supplemented by an immunity statute (L.I.A. § 35-802). The examiner's report to the Superintendent may be published in a newspaper (L.I.A. § 35-418).

Regulation and supervision through the potent instrument of examinations, the accepted procedure in insurance and banking, is not contemplated or provided under the 1933 Act, and has not been the practice of SEC under the 1940 Act.[4] The unavoidable shortcomings of mere "disclosure" are emphasized by the volunteered comment of SEC's expert that, "of course, many matters relating to solvency could only be determined on examination" (R. 268).

Sanctions against misrepresentations or misleading

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[3] The National Association of Insurance Commissioners has recommended standard examination laws and provided state authorities with manuals to standardize examinations (R. 121). The extensive scope of a typical insurance company examination was described by the SEC expert (R. 117-18).

[4] SEC 23rd Annual Report for 1957, page 160:

> ". . . Because of urgent needs for man-power for other functions under the Investment Company Act, it has not been possible to make as many inspections as the Commission thinks desirable, and only six inspections were completed during the fiscal year 1957. This program will be continued to the extent that other workload and appropriations permit."

statements. The Life Insurance Act blankets this field:

The company is subject to revocation of authority to do business, its agents to cancellation of license, if any officer, director, general agent, solicitor, broker, or other person falsely represents the terms or benefits of a policy, "or the dividends or shares of surplus to be received thereon," or other facts concerning the company's operation (L.I.A. § 35-714). Congress here clearly contemplated policies under which a share of surplus would inure to policyholders.

Advertising standards are set, and violation is a misdemeanor (L.I.A. § 35-409, § 35-410). Directors are personally liable for any of eight types of misconduct, including false notices or deceiving the public (L.I.A. § 35-526). A director, officer, agent or employee wilfully making any false statement in any statement required by law is subject to imprisonment for 2-10 years (L.I.A. §35-408). The license of a general agent, agent, or solicitor may be suspended or revoked for any of eight reasons, including misrepresentation or a finding that he is "untrustworthy" (L.I.A. § 35-426).

Organization. Proposed articles of incorporation, together with $10,000 bond, are filed with the Superintendent, and a newspaper notice is required (L.I.A. § 35-502). The Corporation Counsel of the District of Columbia examines the proposed articles and, if he so finds, certifies them to be in accordance with law L.I.A. § 35-503). The Company must deposit secuities of not less than $100,000 to protect policyholders (L.I.A. § 35-415, § 35-416). Pending organization, the Superintendent may examine any person under oath, and all books and records (L.I.A. § 35-506). He must be satisfied as to the company's qualifications before he authorizes it to act, and he may refuse to issue or renew a certificate of authority if issuance or renewal "would adversely affect

the public interest" (L.I.A. § 35-404). The Superintendent's certificate of authority to the insurance company (L.I.A. § 35-503) is on an annual basis (F.F. 6, 8, 9, R. 96), revocable for impropriety (L.I.A. § 35-405). The company must keep its principal office and its records in the District (L.I.A. § 35-204).

Policies. All life insurance and annuity policies must be approved by the Superintendent (L.I.A. § 35-705, § 35-708). They must include standard provisions (life, L.I.A. § 35-730; annuities, L.I.A. § 35-705). Certain other types of provisions are prohibited (L.I.A. § 35-704). All applications, riders, and endorsements relating to annuities must be approved (L.I.A. § 35-705).

SEC does not pass on the merits of, or approve, any security.[5] It is a felony to represent that it does so (1933 Act § 23, 15 U.S.C. § 77w; see also R. 726).

Investments. All investments must be in media approved by the Life Insurance Act as lawful for insur-

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[5] Cf. address by SEC Chairman J. Sinclair Armstrong, to Investment Bankers Association of America, Nov. 26, 1956: ". . . the Federal securities laws do not, and I hope never will, give the Commission power to pass on the merits of securities."

Cf. also testimony of Harold E. Wood, Chairman of Board of NASD, in March, 1955 with respect to the situation in uranium stocks:

> "We . . . are acutely aware of the problem . . . There is nothing that we can do . . . except as there may be bad practice in the sale of those securities. After all, they have to register in one form or another with 'SEC' which is purely a matter of disclosure . . . It is not a matter of the quality or lack of quality of the stock . . . and when the issue is registered with the SEC and there is full disclosure, they are helpless and we are helpless to do anything about that . . . If you do anything else, though, than require a full disclosure, you are getting into a paternalistic situation." STOCK MARKET STUDY, *Hearings before Senate Committee on Banking and Currency*, March 8, 1955, pp. 322-323, 325.

ance companies (L.I.A. § 35-535), described at pp. 38-39 *supra*.

Sales activities. VALIC, like other life insurance companies, operates through the agency system (F.F. 25, R. 99). Each general and soliciting agent must be licensed by the insurance authority of his State/District (ibid). The applicant for an agent's or broker's license must supply full details, some specified in the law, "and such other information as the Superintendent may require" (L.I.A. § 35-425, § 35-428). An applicant for a broker's license may be subjected to examination (L.I.A. § 35-428). When the Superintendent is satisfied of the qualifications and trustworthiness of the applicant, he issues a license on an annual basis (L.I.A. § 35-425, § 35-428).

Superintendent's power to suspend company operations. The Superintendent may suspend the authority of any life insurance company to operate when he considers further transaction of business hazardous to policyholders, creditors or "the public" (L.I.A. § 35-405). After notice and hearing, he may revoke the authority to do business for any of eleven reasons, including impairment of capital or surplus, failure to comply with the law, misrepresenting the "terms of any policy," or use of "any name or title of any policy . . . . misrepresenting the true nature thereof" (L.I.A. § 35-405). He may apply to the District Court for a show cause order to take possession of the company's property and conduct its business for any of six reasons, ranging from insolvency, to a finding that further business will be hazardous to policyholders, to a general finding of "activities against public policy" (L.I.A. § 35-419).

Annually the Superintendent examines and certifies the valuation of VALIC's policy reserves (L.I.A. § 35-701(a); D. Ex. 1, R. 812). The statute vests in

the Superintendent discretion with respect to reserves for life insurance policies providing a varying amount of insurance or varying premiums, for annuities, and for other forms of coverage (L.I.A. § 35-701(c)(2)(B).

The Insurance Superintendent, vested with such powers, obviously cannot be downgraded, as SEC would desire, to a minor officer merely concerned with solvency (See SEC Br. 13, 34). Much less is he the mere ministerial officer that NASD would make him on the basis of an inapposite citation of the 1908 decision of *Drake* v. *United States ex rel. Bates,* 30 App. D. C. 312. The *Drake* case dealt with the first District Insurance Law (Act of March 3, 1901, 31 Stat. 1189 at 1289), which consisted of less than five pages (13 sections), and related solely to the companies, fixing no standards for agents. It was not this rudimentary regulatory scheme which existed in 1933, 1940, and 1945 when Congress made clear its intention to preserve the state regulation of insurance.

D. THE McCARRAN ACT BARS SEC FROM REGULATORY JURISDICTION OVER VALIC OR ITS POLICIES

SEC attempts to deal summarily with the McCarran Act, and NASD dismisses it in one page (SEC Br. 54, NASD Br. 51). That a basic ground of the decision of both lower courts is afforded such a cursory treatment suggests an inability to meet the issue head-on.

SEC argues that the term "business of insurance" in the McCarran Act "goes no further than the insurance exemptions of the Securities Act and the Investment Company Act" (SEC Br. 55). This misreads the legislative history, the Congressional intent, and the clear meaning of all three Acts:

The McCarran Act is a broad and all-inclusive statute by which Congress, until it legislates otherwise, relinquished to the states the regulation of the "busi-

ness of insurance." The District Insurance Laws, summarized above, show the scope of such state regulation. Section 3(a)(8) of the 1933 Act and § 3(c)(3) of the 1940 Act, in contrast, were designed to exclude particular aspects of the business of insurance from the reach of those statutes in order to avoid confusion and duplication within the scopes of the Acts of which they were parts. When this was made clear by the excluding provisions, Congress had no occasion to consider other phases of the industry's activities.

Of course, "there is no basis for the assumption that Congress meant by insurance anything different in one statute from the others" (SEC Br. 55). But the word "insurance" does not stand alone in any of the Acts. In each, it is part of a phrase. The fact that each of these distinct terms or phrases contains the common word "insurance" affords no support to SEC's effort to equate them all. Congress has a full appreciation of the meaning of "insurance" and has mentioned it not only in the Securities Acts but in other statutes.[6] These various references were not for the purpose of regulating the "business of insurance" and were not intended to supersede state regulation.

SEC advances the contention that it would be "unreasonable" to give weight to the decisions of the individual state insurance commissioners "since such an interpretation would result in the provisions of the securities law being inapplicable in some states and applicable in others" (SEC Br. 55). This assertion

[6] For example, Congress has authorized the Interstate Commerce Commission to regulate freight forwarders as to insurance of the property they handle (49 U.S.C. § 1003); the Secretary of Agriculture to require a warehouse license to include insurance in the bond furnished (7 U.S.C. § 247); the Federal Housing Administration to insure mortgages (12 U.S.C. § 1713 et seq.); the Housing and Home Finance Administrator to insure realty which he acquires (42 U.S.C. § 1544); etc.

is a complete non sequitur which attempts to turn the issue from the case before the Court to academic, imagined possibilities which have no factual existence.

This litigation is concerned solely with the facts in this record: The respondents have been authorized under the insurance laws of the District and six states to offer in those jurisdictions, as one of their policy products, the variable life annuity. Obviously, such companies cannot do business in a state in which they have not been licensed by the state insurance authorities, and there is no contention that VALIC has done so. There is nothing either unusual or sinister in variation in state insurance laws, or in the fact that frequently a form of insurance approved in one state is not approved in another.

Hence this action is not concerned with academic questions about states where local insurance laws at this moment do not permit life insurance companies to write variable annuities. Probably this is the situation in Connecticut.[7] That creates no problem for SEC: if life companies cannot write these policies in Connecticut, it is doubly certain that no other type of organization can do so.

SEC concedes, as it must, that "insurance commissioners in some states and the District of Columbia have determined that these contracts are insurance" (SEC Br. 13-14) and that VALIC is an insurance company (SEC Br. 14, 52). The insurance commissioners have made these affirmative determinations under the insurance laws of their respective states/Dis-

[7] *Spellacy* [Insurance Commissioner] v. *The American Life Insurance Ass'n*, 144 Conn. 346, 131 A. 2d 834 (1957), though pressed by both SEC and NASD, has no bearing on the issues of this action. The Court was construing the state's insurance laws and did not hold the variable endowment to be a "security." See pp. 90-91, *infra*

trict. Now SEC asks this Court to permit SEC, by its "contrary interpretation" (SEC Br. 14) of such state District insurance laws, to overrule the affirmative determinations of these District and State insurance authorities. This argument (SEC Br. 44) is in direct conflict with the position taken in this Court nine months earlier by the Federal Trade Commission. Said the Counsel for the FTC:

> "the issue before the Court is not whether the Federal Trade Commission Act can be applied so as to override state policy specifically expressed either in statutes or administrative action. Congress, we think, has resolved that issue in the negative . . ."
>
> FTC Brief p. 23 (repeated p. 39), in *Federal Trade Commission* v. *National Casualty Co.*, October Term 1957, Cause No. 436.

The state insurance commissioner does not determine whether a given contract is a "security" subject to the jurisdiction of SEC under the federal Securities Acts. The District/state insurance commissioner, however, has both the authority and the duty to determine, under the insurance laws of his jurisdiction, whether organizational papers submitted to him will constitute the charter for an insurance company, and whether tendered forms of contracts represent lawful coverages to be sold by insurance companies doing business in his state under his regulation. It is noteworthy that SEC does not contend that any of the decisions relating to VALIC which have been made by the several insurance commissioners were incorrect under the respective state/District insurance statutes.

When the question arises under state law as to whether a given corporate structure shall be authorized and regulated as an insurance company, or a given contract shall be approved for sale by insurance com-

panies as a part of the business of insurance under state law, only chaos could result from holding that the state insurance commissioner and the SEC are empowered to give directly conflicting rulings.

SEC's next argument is based on a statement (SEC Br. 59) which is so inaccurate that VALIC quotes to avoid possible misconstruction:

> "The only basis on which it could be argued that the McCarran Act . . . [bars SEC] . . . would be . . . that, insofar as regulation by [SEC] differs from that of the *state insurance commissioner*, it would thereby 'invalidate . . .' [etc.] . . . the State's *insurance* laws. But this is not realistic in the light of the *specific clauses in both Acts*, Section 18 of the Securities Act (15 U.S.C. 77(r)) and Section 50 of the Investment Company Act (15 U.S.C. 80a-49), *preserving to the state regulatory bodies their jurisdiction*" (emphasis added).

This statement erroneously represents to this Court that the cited sections relate to "state insurance commissioner[s]" and "State's insurance laws." Neither statute (quoted SEC Br. 65 and 67) has any reference to state insurance laws or insurance commissioners. They refer solely to the survival of jurisdiction of state securities administrators.

SEC at Br. p. 61 acknowledges state insurance regulation, but asserts that dual regulation "in certain of these areas" was contemplated by Congress. SEC adds to the two sections mentioned in the quotation above, § 12(g) of the 1940 Act. That subsection, not quoted by the SEC Appendix, appears in § 12: "Functions and Activities of Investment Companies." Since insurance companies are excluded from the definition of "investment companies" (see p. 99, *infra*), it can not be a provision contemplating dual regulation. It permits "investment companies," de-

spite the prohibition in § 12(d)(2), under certain conditions to purchase stock in state regulated insurance companies. The final sentence, referring to insurance commissioners, manifestly was intended to reemphasize the fact that the 1940 Act was not invading the field of insurance regulation. It did not vest in SEC jurisdiction with respect to the company in whose stock the investment company invested. What SEC's line of argument, if accepted, would do to state and federal systems for the regulation of insurance companies, banks, common carriers, communications agencies and public utilities staggers the imagination.

Putting aside this manifestly specious line of argument (which NASD does not even advance), we reach the question of whether SEC's attempt to regulate VALIC would supersede, invalidate or impair present District/state insurance supervision. On this point SEC pleads in avoidance: it argues that, irrespective of such supersession, invalidation or impairment, it has jurisdiction because (it says) the 1933 Act and the 1940 Act "specifically relate to the business of insurance" (SEC Br. 60). To support this theory, SEC says the Acts contain "references to insurance." The only reference to "insurance" in the 1933 Act is § 3(a)(8), designed to make clear that insurance contracts are not within that statute (Point III *infra*). In the 1940 Act there are references, cited by SEC, the major one excluding insurance companies from its reach, and others housekeeping provisions, and catch-alls to make sure that no hiatus of regulation occurs through legislative oversight. SEC cites these provisions and drops them, presumably because it is unable to point to any facts in or outside the record to indicate that they have ever been viewed as a warranty for SEC's superseding state insurance regulation.

The McCarran Act provides (§ 2(b)) that an Act of Congress shall have potency to invalidate, impair or

supersede state laws regulating insurance only if the federal act "specifically relates to the business of insurance." It seems too clear to require argument that Congress did not intend that such destructive effect should be given to every casual reference to "insurance" in any federal statute. This saving clause was designed to avoid conflict should Congress enact statutes subjecting to federal regulation the business of insurance or some aspect of it pursuant to a considered legislative judgment that federal regulation was required.

SEC asserts (Br. 57) that in *Maryland Casualty Co.* v. *Cushing,* 347 U.S. 409 (1954), "this Court had occasion to determine the extent to which federal law had been suspended . . ." This characterization overstates the *Cushing* opinions. That case "involved an alleged clash between Louisiana's direct action statute and the [federal Limited Liability] Act. The majority concluded there was no clash." Mr. Justice Clark, for the Court, in *Lake Tankers Corp.* v. *Henn,* 354 U.S. 147, 153 (1957). In *Cushing,* it will be recalled, the justices split four-four-one. Four (opinion by Mr. Justice Frankfurter) concluded that the state had no power to intrude in the exclusively federal maritime jurisdiction, and set the McCarran Act aside as irrelevant (347 U.S. at 413). Four (opinion by Mr. Justice Black) concluded that the decision of the lower court should be affirmed on several grounds, one of which was the McCarran Act. They found in the fact that the McCarran Act followed *South-Eastern Underwriters*

> ". . . no reason for giving the law an unnaturally narrow construction squarely in the teeth of the plain, normal, everyday meaning of the language used. The Act rather shows the strong purpose of Congress to permit states to continue regulating insurance as they always had" (347 U.S. at 437).

Mr. Justice Clark concluded that determination of the insurer's liability should be deferred until conclusion of the limitation of liability proceeding. To resolve the deadlock, this was the order entered. The *Cushing* and *Lake Tankers* opinions show that SEC misreads the views of Mr. Justice Clark (SEC Br. 58).

The *Cushing* case dealt, at best, with a fringe area of state/federal conflict in the field of insurance. Here the Court is concerned with the heart of the business: the organizational form and capital structure of the insurance company itself, and the scope and form of the policies which the insurance company may offer under state statutes. As stated shortly after the *Cushing* case, in litigation involving marine insurance:

> "... state regulatory power, exercised with federal consent or acquiesence, has always been particularly broad in relation to insurance companies and the contracts they make.
> "... the McCarran Act, was designed to assure that existing state power to regulate insurance would continue. ..."
> *Wilburn Boat Co.* v. *Fireman's Ins. Co.*, 348 U.S. 310, 314, 319 (1955).

The Court is confronted here with a conflict between the affirmative ruling of the District and state insurance commissioners, and the contentions advanced by SEC. In the light of the evident Congressional intent to dovetail state and federal regulation, this is a matter for state administrative decision if we are to recognize "the cooperative conception" of federalism that "the National Government and the States are mutually complementary parts of a *single* governmental mechanism all of whose powers are intended to realize the current purpose of government according to their applicability to the problem in hand." Corbin, *The*

Passing of Dual Federalism, 36 Va. L. Rev. 1, 19 (1950).[8]

III

VALIC's VARIABLE LIFE ANNUITY POLICIES ARE NOT "SECURITIES" WITHIN THE SECURITIES ACTS

A. THE DISTINCTION BETWEEN "SECURITIES" AND "INSURANCE"

The difficulty with SEC's case is that SEC is trying to induce the courts to disregard the fundamental distinction between an "insurance contract" and a "security." Though both involve collective activity, they are utterly different in (a) the risks involved and (b) the basis of realization (payments).

Risk: the contingency of life.

We have seen that the life contingency risk under the annuity contract is longevity. "The health of an annuitant affects the substance of an annuity contract as materially as the the health of an assured affects the substance of a life insurance contract.... In either case, death determines the contract." *Woodworth* v. *Prudential Ins. Co.*, 171 Misc. 585, 13 N.Y. Supp. 2d 145, 148-149 (Sup. Ct. 1939). Hence premiums paid by insured A may be applied in whole or in part to pay benefits to insured B.

A "security," on the other hand, does not involve any life contingency. Whether a particular security holder lives or dies has no financial significance either

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[8] This Court, speaking of the power of the Interstate Commerce Commission in exceptional fact cases to deal with intrastate rates, recently reiterated that "the justification for its exercise must 'clearly appear'" because of "the inevitable irritations inherent in the conflict." *Chicago, Milwaukee, St. Paul & Pacific R. Co.* v. *Illinois*, 355 U.S. 300 (1958).

to the organization issuing the security, or to other security holders. As SEC itself says, "His risk is identical to that of all others who purchase the same security" (Br. 33-34).

Realization:

In life insurance annuities, the annuitant receives an amount which differs from that of other policyholders, reflecting age, sex, life contingency, and the time when premium payments began. Realization depends on facts unique to the individual: when born, sex, and date of death. The annuitant cannot outlive his annuity; it does not survive him.

Every holder of a "security," a participant in a common enterprise, receives the same payment as every other holder of the security, under exactly the same circumstances (conceded, SEC Br. 33-34, quoted *supra*). A security produces income or realization of principal totally unrelated both to the duration of life of the investor and to the lives of the group of investors.

This personal character of life insurance and annuities is one of the reasons, of course, why life annuity policies are not traded in as "securities." Securities men who testified for SEC confirmed that never had they sold anything dependent for its existence on the continued life of the purchaser (R. 306), and that there is no market for a life annuity (R. 392).

See *United States* v. *Leslie Salt Co.*, 350 U.S. 383 (1956) wherein, in deciding whether promissory notes fell within the language of the statute: "all instruments, however termed . . . known generally as corporate securities" and within the Treasury ruling as "instruments having the general character of investment securities", this Court said, at page 393:

> "The essence of an 'investment security' is, of course, marketability, and this basic feature the Leslie Salt notes did not have."

No court has ever held to be a "security" a policy issued by an insurance company under the supervision of state insurance authorities, which contract, approved by such authorities, provided benefits calculated on actuarial principles and dependent as to amount and duration on age, sex, and contingency of the life of a specific individual.

This Court applied this analysis in *Helvering* v. *Le Gierse,* 312 U.S. 531 (1941) (cited NASD Br. 20, 31, 33, 39, 45, not cited SEC Br.) and *Estate of Keller* v. *Commissioner,* 312 U.S. 543 (1941) (cited NASD Br. 39, 44, 45, not cited SEC Br.). Those cases dealt with the exemption from federal estate taxes of funds received "as life insurance." The insurer, for a lump sum, issued to a purchaser (i) a policy of life insurance, and (ii) a life annuity policy. The premium was calculated so that the ostensible mortality risks cancelled. The Court held that the funds derived from such an arrangement would not be treated as having been received "as insurance" under tax law because there was no shifting and distribution of the mortality risk. The "company assumed no pecuniary risk in respect to the duration of Mr. Tyler's life." *Helvering* v. *Tyler,* 111 F. 2d 422, 426 (8th Cir. 1940). Said the lower court in *Commissioner* v. *Keller's Estate,* 113 F. 2d 833, 835 (3rd Cir. 1940):

> "Mrs. Keller's death, no matter when it occurred could never require the company to look to funds contributed by other policyholders in order to make the life insurance payment."

B. THE DEFINITION OF "SECURITY" IN THE SECURITIES ACTS DOES NOT COVER VARIABLE ANNUITIES

SEC starts with the contention that the Securities Acts "were designed to provide protection for investors purchasing securities *similar to* the variable annuity" (SEC Br. 16, emphasis added). Nearly 25% of the SEC Brief (pp. 19-33) attempts to analogize the premium payment period of VALIC's policies to "periodic payment plans" of investment trusts in the 1930's.

The material relating to periodic payment plans, quoted at such length by SEC, comes from SEC reports dated in 1939.[9] It is somewhat difficult to believe that it was influential in the mind of Congress when it framed the definition of "security" in 1933. SEC also quotes from Senate Report No. 1775, 76th Cong., 3d Sess. (1940), but SEC omits the following unequivocal statement from that report:

> ". . . the bill specifically excludes . . . insurance companies . . ." (pp. 12-13).

A similar statement appeared at p. 12 of House Report No. 2639, H. R. 10065 (1940).

In its effort to fit VALIC's policies into the mold of a "security," SEC argues that they are "certificate[s] of interest or participation in any profit sharing agreement" or "investment contracts" (Br. 36). SEC cites *SEC* v. *W. J. Howey Co.*, 328 U.S. 293 (1946) and *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943). In the *Howey* case, this Court said:

> "The test is whether the scheme involves an investment of money in a common enterprise with

[9] SEC's entire discussion of periodic payment plans is inapt. The Investment Company Act of 1940, § 2(a)(26), defines periodic payment plan certificates to mean certificates "representing an undivided interest in certain specified securities or in a unit or fund of securities . . ."

profits to come solely from the efforts of others" (328 U.S. 301).

SEC planned its case on this language. Count One of the Complaint, on which all other Counts rest, asserts the misconception that variable life annuities are interests in a "common enterprise." Count One contains that term eleven times (R. 4, 5). Yet neither the Findings of Fact nor either of the lower courts' Opinions even mentions "common enterprise." SEC ignores "common enterprise" in its Statement of Questions Presented and in its Statement of the Case. SEC quite evidently now realizes that annuity policies, whether fixed-dollar or variable, do not involve a "common enterprise." In annuities, the interest of each annuitant is inherently adverse to those of all other annuitants: the group pays and the annuitant prospers when he lives beyond his life expectancy; while the group gains and the annuitant loses when he dies early (R. 467). Variable annuities, like other insurance policies, are the very antithesis of a common enterprise. A life annuity rests on shifting the risks incident to the contingency of life. There was no such insurable contingency involved in *Howey* or *Joiner*.

Not only are variable life annuities fundamentally different from the *Howey-Joiner* type of "investment contract," but equally distinct are the motivations of the purchasers of these two disparate types of instruments. In the *Howey* and *Joiner* cases, the purchasers were moved solely by a desire for profit.[10] As a matter of common sense, every purchaser of an an-

[10] In the *Howey* case this Court referred at page 300 to the investors' "paramount aim of a return of their investments" and said: "Such persons have no desire to occupy the land or develop it themselves; they are attracted solely by the prospects of a return on their investment. . . . The resulting transfer of rights in land is purely incidental."

nuity, whether fixed-dollar, or variable, knows that the aggregate amount (number of payments) to be paid to him is unpredictable, since it will depend on the length of his individual life, and that he cannot have any reasoned basis for expecting a "profit." SEC gives no record reference (none exists) to support its claim that VALIC policyholders bought or looked to the policy as a profit-making venture. The undisputed testimony of SEC's policyholder witnesses (R. 360-376) shows the opposite.

The purchaser of a variable life annuity has a two-fold motive. Primarily, he desires an income guaranteed to continue as long as he may live. As the Court of Appeals said: "But perhaps the most important risk that the purchaser desires to shift when he buys an annuity is that he will live longer than his funds will last" (R. 890). Subordinately, as he enters a contractual relationship which may span half a century or more, he seeks an annuity on which payments will tend to adjust for the changing purchasing power of his dollar. To this end, he assumes two risks, one identical with, one the converse of, risks assumed by anyone purchasing a fixed-dollar life annuity:

(a) He assumes the risk that, due to brevity of his life, the total annuity payments may return only a small proportion of his aggregate premium payments. So of all annuity policies.

(b) He assumes the risk that in periods of declining investment results his annuity payments may be smaller than in periods of rising business activity. This is the reciprocal of the fixed-dollar annuitant's risk of loss of purchasing power when prices are high and gain of purchasing power when they are low (R. 431-432).[1]

[1] Cf. The proposal that trustees in the United Kingdom be prohibited from investing trust funds in obligations or claims expressed in monetary sum—certain—on the ground that historical

These are not the motivations, and this is not the economic context, of one who enters a "common enterprise" for "profit."

In the *Howey* case this Court pointed to the statutory purpose of the Securities Act as relating to the "types of instruments that in our commercial world fall within the ordinary concept of a security" (quoted by the Court from H. Rep. No. 85, 73d Cong., 1st Sess., p. 11). In the *Joiner* case the Court said: "The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect" (320 U.S. at 352).

Under a definition in terms identical to the 1933 Act, yet omitting the insurance exemption found in the 1933 Act, § 3(a)(8), *Haberman* v. *Equitable Life Assurance Society,* 224 F. 2d 401, 225 F. 2d 837 (5th Cir. 1955), cert. denied 350 U.S. 948 (1956), held that a life annuity is not a "security." The decisive consideration was the life contingency aspect of the contract. Said the Court:

> ". . . Certainly annuities issued by regulated insurance companies are not at all similar to the securities specifically enumerated in the statute. In fact, we would not regard 'investment contract' as a correct description of an annuity . . . [What] makes it essentially an annuity is that it is a form of risk-sharing . . . in an annuity, the risk is that the annuitant may live long, outliving his means for his own support. To the extent that insurance or annuities are risk-sharing, they are certainly not investments. It is true that investments or other objectives can be combined in such plans, but they are not of their essence. Besides, we

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evidence shows that these are actually risk investments. "Agenda For The Age Of Inflation" [The Economist (London) August 25, 1951, pp. 435-437].

> perceive a striking difference between the instruments specifically included . . . and insurance and annuity policies of regulated companies . . . the latter are governed by a special statutory scheme, and reserves are required by law to be maintained for them. Thus we think the general words 'investment contract' cannot be reasonably interpreted as including something so dissimilar to the specifically named instruments, as the annuity in this case. Whether they might include an annuity issued by one not a regulated insurance company, we need not decide" (224 F. 2d at 406).

Accord: *Rinn* v. *New York Life Ins. Co.*, 89 F. 2d 924 (7th Cir. 1937), cert. denied, 302 U.S. 753 (1937); *Bates* v. *Equitable Life Assurance Soc.*, 206 Minn. 482, 288 N.W. 834 (1939); *Hamilton* v. *Penn Mutual Life Ins. Co.*, 196 Miss. 345, 17 So. 2d 278 (1944).

Petitioners have both gone far afield in their effort to unearth something that might be claimed to support their position. NASD (but not SEC) cites the Uniform Securities Act; SEC (but not NASD) cites an alleged "poll" of securities administrators.

The Uniform Securities Act (NASD Br. 23), as amended in August, 1958, can give no comfort to petitioners. It was drafted with "advice" from (among other "security" sources) plaintiff SEC and intervenor NASD.[2] The provisions designed to strike at the variable annuity policy first appeared in a third draft released in April, 1956, almost one year after the first draft.[3] Though the draftsmen, and

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[2] Loss & Cowett, Blue Sky Law, pp. 233-235 (1958) and dust-jacket listing "advisers."

[3] On March 24, 1956, the New York Times reported a press conference with the Chairman of the SEC:

> "No decision, he said, had been made so far on the question of variable annuities. The Commission has deferred hearings

the SEC/NASD "advisers" must have been familiar with the impending institution of this action, which they were attempting to pre-judge, there is no indication that any insurance authorities were consulted. In August, 1958 the Commissioners on Uniform State Laws, meeting in Los Angeles, amended the Uniform Act to make clear that it was not intended, and should not be cited, to support a claim that the variable life annuity is a "security."[4] The amendments should avoid uncertainty in future state legislation and thus forestall such unseemingly administrative quarrels for jurisdiction as that now pending in West Virginia.[5]

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until it can make up its mind whether these are 'securities' as defined in the Securities Act of 1933 and the Securities Exchange Act of 1934."

The New York Herald-Tribune of the same date, reporting the same conference, stated that Mr. Armstrong had "said that Congress ultimately may have to decide whether his agency is to have jurisdiction over variable annuities."

[4] The Commissioners amended the final sentence of the definition of "security" (§ 401 (1)) and bracketed the final clause of § 402(a)(5). The amendment to § 401 (1) eliminated the words "number of dollars" so that it now excludes from "security" an "... annuity contract under which an insurance company promises to pay [a fixed sum of] money . . . periodically." The Commissioners' Comments (as revised), make clear that the purpose of the 1958 amendments was to leave to each state legislature, in the light of its state regulatory system, the determination as to the framework of supervision of life insurance companies issuing variable annuities. As stated in the comment on § 402(a)(5): "Those states which take the position that insurance companies which issue variable annuities are sufficiently regulated by the applicable insurance laws will delete the bracketed language."

[5] The West Virginia action, *State ex rel. Sims, Commissioner of Securities* v. *VALIC*, is referred to SEC Br. 46 and NASD Br. 55. The facts are a matter of record:

On August 24, 1956, the West Virginia Insurance Commissioner promulgated a letter of transmittal (56 WEEKLY UNDERWRITER INS. DEPT. SERV., West Virginia 26-30 (1956), and his regulations

SEC asserts that state authorities differ as to the nature of the variable life annuity (SEC Br. 45). SEC cites a "poll" of state Securities Administrators. C.C.H. Blue Sky Rep., par. 4,711, printed a March, 1957 report of the variable Annuity Committee of the National Association of Securities Administrators. Presumably 47 securities administrators[6] were "polled." The question was: "Under the existing laws of your state, do you [the securities administrator] consider

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governing the sale of variable annuities (D. Ex. 17, R. 406, 824). The letter of transmittal expressed the considered view of the Commissioner:

> "We have concluded that the laws of this State authorize the solicitation and sale of variable annuities by a licensed life insurance company. . . . The regulations follow in general the principles laid down in the report of the Variable Annuities Subcommittee . . . which was adopted by the N.A.I.C. [National Association of Insurance Commissioners] . . . The members of this Department are convinced that properly sold variable annuities have a place in the insurance business world . . ."

On Jan. 9, 1957, Sims, the State Auditor and ex officio Securities Commissioner, purported to issue an order directing VALIC to cease its activities. VALIC brought an action against Sims to test this Order. Sims answer was signed by the state's Attorney General and by the general counsel of NASD (who later obtained leave to remove his name). On final hearing, the Court held that there was no statutory authority for the order, and that it was void. *Variable Annuity Life Ins. Co.* v. *Sims*, Circuit Court, Kanawha County, West Virginia. There was no appeal.

On August 23, 1957, on the relation of Sims, the pending action was brought asking that VALIC be enjoined from carrying on its business under the license and supervision of the Insurance Commissioner. No temporary injunction issued. The case was tried on July 21, 1958. Counsel for NASD and counsel for National Association of Investment Companies were present and advised the Attorney General. NASD filed a brief in the case. The Court has not yet decided the case.

[6] Nevada has no securities administrator; Alaska was not a state.

variable annuities as securities?" The answers are revealing:

Yes	No	Undecided	No answer
21	9	7[7]	10

These figures, objectively examined, bear a significance which can be of little comfort to SEC. Over a period of 25 years, many state blue sky laws have been amended, and in those amendments the "security" definition of the 1933 Act has been influential. Every security administrator "polled" undoubtedly knew of the pendency of this action and of SEC's contentions. The question submitted virtually invited an affirmative answer. Yet only 45 per cent of the state securities administrators were moved to answer "yes," from which the NASA Committee drew the conclusion: "Nearly all of the states consider variable annuities as securities" (C.C.H. Blue Sky Rep. Par. 4711).

The position of the National Association of Insurance Commissioners is clear. It has expressed officially its view that in any state where the sale of variable annuities is authorized,

> "supervision over the company including the issuance and sale of variable annuity contracts should

[7] Iowa answered that there was no official opinion. When the basic report was presented to the NASA convention in October, 1957, Iowa's Deputy Securities Commissioner presented an unofficial view, that regulation should be by the insurance department. He said:

> "At the moment, as we see it, we do have insurance companies engaged in the operation of a trust fund from which the investment return is a very necessary and important factor. Now the addition of a variable annuity consideration does not change in a very material way this basic underlying fact. . . ." PROCEEDINGS 40th CONVENTION N.A.S.A. p. 43 (1957).

come under the jurisdiction of the insurance department." (1956 Proceedings of the National Association of Insurance Commissioners, Vol. 1, 165. Quoted, NASD Petition for Certiorari, p. 45).

Unable by fact, logic, or precedent to drag VALIC's variable life annuities within the Securities Acts definitions of "security," SEC for the first time has advanced in this Court its last-ditch position: it would lift out of VALIC's operations the deferred or optional life annuity, and would split it apart so that SEC could have jurisdiction during "the pay-in period . . . whatever the determination with respect to the pay-out period" (SEC Br. 43). NASD, even at its most extreme, has never urged a regulatory muddle so grotesque.

Piercing the trappings of advocacy, we see that SEC proposes that each VALIC deferred life annuity policy be artificially torn into two or more fragments of contracts.

For analysis, assume a deferred annuity issued to a 35 year-old male with a 30 year period of premium payments, with provision for waiver of premium in event of disability, and with life insurance coverage during the 30 year deferred period (Pl. Ex. 1, R. 125, 567, and D. Ex. 29, R. 406, 840). Under its latest proposal, SEC would take some undefined sort of temporary jurisdiction over whatever portion of this whole policy it might split off and attribute to the annuity benefits. SEC would exercise such jurisdiction for the first thirty years, with the state insurance authorities during those three decades relegated to some undefined never-never land in which they would struggle to find some way to regulate those portions of the policy which SEC might be induced to admit related to life insurance and disability waiver.

Since all the company's assets underlie its reserves for the several types of coverage, SEC and the state insurance authorities would be involved in regulating the same company and the same assets. Then would come that instant—a separate one for each policy—when the passage of time brought into effect the annuity payment provisions: the SEC apparently would fade away without trace, and the long obscured insurance commissioners would emerge to supervise the policy during the remaining years of its effective period. Merely to state such an idea destroys it. It overdignifies the SEC argument even to observe that nothing in the legislative history of any of the federal acts indicates that Congress contemplated the possibility of such a preposterous administrative imbroglio. The short answer appears in *Jordan* v. *Group Health Association,* 71 App. D. C. 38, 107 F. 2d 239, 245 (1939):

> "It is the plan as a whole, not artificially disjointed and segregated single phases of it, with which we are concerned."

C. FALLACIOUS DISTINCTIONS

1. The "fixed dollar" fetish

SEC puts major reliance on the contention that the essential and indispensable characteristic of any life insurance annuity must be a provision for fixed-dollar payments. From this (fallacious) major premise SEC leaps to the non sequitur that a contract providing for the liquidation of the company's liability over the uncertain period of the contract holder's life through periodic payments which are variable, yet precisely determined by contract terms, is a "security."

If SEC's contention were correct—and we shall see that it is not—VALIC's policies would meet the test:

the variable annuity benefits are "fixed amounts" since, as SEC's expert witness agreed, they are definitely determinable on the basis of the formula set out in the policy (R. 254). Fully applicable in this context is the legal maxim, "that is certain which is, by necessary reference, made certain." See *United States* v. *Smith,* 18 U.S. (5 Wheat.) 153, 159 (1820); *Mobile & Ohio R.R. v. Tennessee,* 153 U.S. 486, 497 (1894); *Travelers Fire Ins. Co.* v. *Ranney-Davis Mercantile Co.,* 173 F. 2d 844, 851 (10th Cir. 1949.) This maxim has been applied in determining that an annuity which had a variable feature nevertheless provided "a certain specified sum." *In re Bourn's Estate,* 25 Cal. App. 2d 590, 78 P. 2d 193, 198 (1938).

Aside from the maxim of certainty by established standards of calculation, the SEC contention that every life insurance annuity must provide for fixed-dollar payments has no support in applicable precedent and has been rejected by courts, legislatures, and scholars. It was, of course, rejected by the trial court in the unequivocal finding that "A variable annuity contract, as provided by contracts issued by VALIC, is an annuity . . .," and describing it (F.F. 30, R. 100). As NASD points out (Br. 18), neither it nor SEC excepted to the trial court's findings.

The SEC and NASD briefs accept as authoritative in the insurance field three scholars: Huebner (cited NASD Br. 35, 36, 40, 42), Maclean (cited NASD Br. 34, 35, 36, 40), and Mehr (cited SEC Br. 39). All agree that the insurance definition of a life annuity does not require fixed-dollar payments. Maclean and Mehr so testified at the trial (R. 459, 486). Huebner states in the latest edition of his work:

> "Broadly, an annuity may be defined as a periodic payment made during a fixed period or for the

> duration of a designated life or lives. If the payments are made with reference to life contingencies, the contract is known as a life annuity."[8]

Of the variable annuity, Huebner says in part (p. 100):

> "Instead of providing for the payment each month of a fixed number of dollars, the variable annuity provides for the payment each month or year of the current value of a fixed number of annuity units . . ."

The Securities Act of 1933 does not require frozen, fixed dollar payments. It exempts "any . . . annuity contract or optional annuity contract issued by a corporation subject to the supervision of the insurance commissioner . . ." (1933 Act, § 3(a)(8), 15 U.S.C.A. § 77c).

The District Insurance Code makes no such requirement. There is no contention here that VALIC's policies are unlawful under the District insurance statutes.

The insurance statutes of the District, West Virginia, Kentucky, Arkansas, Alabama, New Mexico and North Dakota make no such requirement. Administering the insurance statutes subject to his jurisdiction, the insurance commissioner of each of these states has approved VALIC's or EALIC's policies and authorized their sale as insurance contracts.

The Federal Government's Treasury Department makes no such requirement. Variable annuity payments are taxable as annuity income. Rev. Rul. 185, 1953-2 Cum. Bul. 202, now incorporated in the Fed. Inc. Tax Regulations § 1.72(b)(3).

Moreover, the variable annuity has received Congressional recognition. In the 85th Congress, 2nd ses-

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[8] HUEBNER & BLACK, LIFE INSURANCE (5th ed. 1958) 91.

sion, Report No. 2277 of the Committee on Ways and Means, which accompanied H.R. 10, relating to the "Self-Employed Individuals' Retirement Act of 1958", it is stated:

> "The restricted retirement policy for which an individual may take a deduction for the premium must fundamentally be an annuity or an endowment policy issued by a domestic life insurance company." (Page 3)

At page 11 of the Report, it is stated:

> ". . . Under subsection (f)(2) no annuity described therein is treated as satisfying the requirements of such subsection if it provides for payments which (after annuity payments begin) may increase for any reason other than dividends or increases in investment income allocable to the policy. A variable annuity therefore can qualify as a restricted retirement policy regardless of increasing annuity payments if such increases are due to increases in investment income, including capital appreciation."

The argument that fixed payments are essential to the insurance concept was rejected in *In re Supreme or Cosmopolitan Council of Brotherhood of Commonwealth*, 193 Misc. 996, 86 N.Y.S. 2d 127 (Sup. Ct. 1949). Each member of a fraternal society made anual payments, which the society invested in income-producing property. Earnings realized, after expenses, were distributed to the members as "dividends." On a member's death, withdrawal, or lapse, his "account" was prorated among the remaining members of his "birth year class." The payments being contingent on the continuance of life, the Court held the transactions to constitute insurance annuities: the fact that the periodic payments were not fixed in amount, but variable, did not change the annuity fea-

ture, since "annuity" does not necessarily mean only "fixed sums payable on specified dates." 86 N.Y.S. 2d at 130. See also 1947 REPORT, N.Y. ATTY. GEN. 214.[9]

Nothing in the District Life Insurance Act suggests that an annuity must (a) guarantee a predetermined minimum level of benefits, or (b) utilize a predetermined minimum assumption as to (1) mortality or (2) investment results.

The SEC must recognize that a life annuity policy issued by a company under insurance regulations would satisfy § 3(a)(8) if it promised any fixed minimum annuity payment, even though the amount be only 10 per cent of that offered by competing insurance companies for the same premium, and even though it be on a participating basis. Such a benefit level might be calculated by actuarial means based on assumptions:

(a) that all annuitants would live to be 110 years old; and

(b) that the company would earn ½ of 1 per cent on the investment of its assets.

Technically this policy would satisfy the apparent yen of SEC for a fixed-dollar minimum but in actual operation an equitable participating feature would make it a variable annuity. Issued by a life insurance company whose assets were substantially invested in common stocks, the hypothetical policy could not be differentiated pragmatically from the annuity policies of VALIC.

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[9] New York Ins. Law § 46 defines "annuities" as "meaning all agreements to make periodical payments where the making or continuance of all or of some of a series of such payments, or the amount of any such payment, is dependent upon the continuance of human life. . . ."

NASD relies (Br. 47-48) (as both SEC and NASD did below) on cases involving wills, trusts and taxes. These decisions were concerned with the transaction from the standpoint of the recipient, whether he was an annuitant, beneficiary, or legatee. None started from the point involved here, the performance of an insurance function by the institution making the payment. The basic issues were of this sort: When does the legacy or interest thereon commence? Shall the corpus be invaded? Is the residue to be charged? They have no relevance to the present controversy.[10] In most, if not all, the decision would have been the same on either fixed or variable payments.

SEC now relies, however, solely on a definition by Lord Coke in the early 17th century and a lay textbook by Clyde C. Crobaugh printed in 1933.

Lord Coke was writing at a time when life insurance, as an institutional service based upon distribution of risk, was in its infancy. Prior to the 17th and 18th centuries, whatever was done in the way of annuities was on a crude basis (R. 479). Modern life insurance stems from the formation over a century later (1756) of The Society for Equitable Assurances on Lives and Survivorships. That company was the first to introduce the idea of varying the amount of premiums according to the entry age of the assured, and its efforts over a period of years to obtain a formal charter were frustrated by the opposition of established forces which feared the competition of its more effective insurance product.[1]

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[10] In their REPLY Brief in the Court of Appeals SEC cited 59 such cases. In this Court, SEC cites none. NASD still cites two (NASD Br. 47-48). They are so manifestly inapplicable that discussion appears unwarranted.

[1] See KNIGHT, THE HISTORY OF LIFE INSURANCE IN THE UNITED STATES TO 1870 (1920) 38-39.

If ancient practices are to shackle our modern economy, however, we should be clear that distinguished scholars do not read Lord Coke's authority as narrowly as does SEC. Thus Pollock and Maitland point to a variable annuity which preceded Lord Coke by centuries:

> "One class of annuities (*sic*) has an instructive history of its own. It consists of the corodies (*conredia*) granted by religious houses . . . . The quantity and quality of the meat, drink, clothes, candles, firewood, that the grantee is to receive will be carefully defined; even the mustard and garlic will not be forgotten."[2]

Crobaugh, recognized in 1933, that the life insurance annuity was not frozen. He said:

> ". . . the forms and kinds of agreements were changed and extended from time to time. . . . Many variations and new agreements came into use as new needs were discerned, and this development is still in progress."[3]

And so it is. Even in the estate and wills field there is no sanctity to "fixed-dollar" amounts. Recently the High Court Justice of Ontario sustained a bequest of a variable annuity which "vested in the beneficiary . . . the right to receive such annuity to be calculated by the trustees in accordance with . . . the procedure laid down . . ." Re *Rogers*, 4 D.L.R. 422, 428-429, 431-433 (1955).

SEC also relies on two cases. Neither was an attempt to enforce a "securities" law. Each determined whether a particular contract was permissible under the insurance laws of the particular state. Each

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[2] HISTORY OF ENGLISH LAW, Vol. 2, p. 134 (1911).

[3] CROBAUGH, ANNUITIES AND THEIR USES (1933) p. 12.

upheld the local insurance commissioner. VALIC agrees that the District/state insurance statutes are the appropriate standards against which to test any contract proposed by an insurance company.

Coastal States Life Ins. Co. v. *Kelly,* [Insurance] Commissioner, Court of Common Pleas, Richland County, So. Car., 1955, unreported (SEC Br. 45, not cited by NASD): there Coastal, a Georgia life insurance company, offered in South Carolina a life insurance policy which included "interim endowments" of $100 a year for 18 years (the first a double amount, $200, after 2 years). The sole issue was the applicability of So. Car. Code (1952) § 37-145, prohibiting an insurance company from issuing any contract offering an "inducement to the taking of insurance." The Insurance Superintendent of South Carolina prohibited issuance of the policy on the ground that the "endowment" provision constituted such an "induce ment." The Court sustained. The SEC reference to this case (Br. 45) misstates both the facts and the holding.

Spellacy, Insurance Commissioner v. *The American Life Insurance Association,* 144 Conn. 346, 131 A. 2d 834 (1957), upheld the Connecticut Insurance Commissioner in ruling that a variable endowment contract could not be issued under present Connecticut law governing fraternal benefit societies. The *Spellacy* contract contained an "option," after 10 years or death, under which "the Association agrees to grant, . . . a variable annuity certificate" for a type of annuity which it might be issuing at the time of election.[4]

[4] The contract provided: "The Variable Annuity Certificate to be issued under this option will be governed in every respect by the terms, conditions, privileges, and provisions which will be contained in the certificate." (Record on Appeal, Connecticut Supreme Court).

The lower court reserved seven questions for Supreme Court decision. Not one even referred to the variable annuity "option." Only one referred to the Securities Law of Connecticut and the Connecticut Court did not answer that question.

With respect to *Coastal States* and *Spellacy*:

(a) There was not the slightest factual similarity to VALIC's officially approved policies; (b) both cases illustrate the effectiveness of state insurance regulation under state insurance statutes; and (c) neither gives any support to a theory that a life annuity policy is a "security" or that SEC should supersede State insurance authorities.

2. The media of company investments

The investment media chosen by an insurance company from those authorized by state insurance laws have never yet been held the criteria for subjecting the company or its policies to any regulatory body other than insurance authorities.[5] The "securities" covered by the Securities Act are those offered to the public, not the issuers' underlying assets. Even as to an issue offered to the public, the Act makes no distinction in its applicability according to whether a bond or stock is being issued; it applies to both equally. *A fortiori,* it is not concerned with whether the issuing company's assets consist of stocks or bonds.

If a relationship between investment results and benefits to policyholders makes a life annuity a "security," fixed-dollar annuities of mutual life insurance companies and participating policies of stock life in-

[5] NASD seems close to appreciating this fact. NASD Br. 42 agrees that "From what source or through what economic methods the insurer acquires the money to meet its contractual obligations is no part of an 'insurance' contract."

surance companies also are "securities." Especially striking is the fixed-dollar participating policy issued in New York by a stock company which offers in that state both participating and non-participating policies: the New York Insurance Law § 216(6) limits the "profits" which may be withheld from annuitants and hence "shall inure to the benefit of the stockholders"; and further provides that

> ". . . . the profits on its participating policies and annuity contracts shall be ascertained by allocating to such policies and annuity contracts specific items of gain, expense or loss attributable to such policies and contracts and an equitable proportion of the general gains or outlays of the company."

The payment of benefits keyed to investment results has long been customary in the life insurance field.

D. THE INSURANCE "EXEMPTION" CONFIRMS THE EXCLUSION OF VALIC's LIFE ANNUITY POLICIES FROM THE SECURITIES ACT OF 1933.

The Securities Act of 1933 § 3(a)(8) "exempts" from the registration requirements thereof:

> "(8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner . . . of . . . the District of Columbia."[6]

The considerations set out earlier in this Brief show that VALIC's life annuity policies are not "securities" within the definition of the 1933 Act.

But the Act contains § 3(a)(8), and for drafting convenience it appears as an "exemption." An "ex-

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[6] "Optional annuity contract" is another term for a deferred annuity contract. See p. .... *supra*.

emption" however, is a provision which removes from the reach of a statute some person, thing, or situation which otherwise would fall within the Act. Congress made unmistakably certain the fact that § 3(a)(8) was not to be viewed as such an "exemption," but was inserted in the Bill to make clear:

> ". . . what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible" (H.R. Rep. No. 85, 73rd Cong., 1st Sess. 15 (1933)).[7]

Congress meticulously defined securities terms used in the 1933 Act, but not the terms used in this exclusion. The test adopted was whether the instrument involved was an insurance contract issued by a company supervised by the State (or District) insurance authorities. Since there is no question but that VALIC is a life insurance company "subject to the supervision of the" Insurance Superintendent, SEC must argue, to escape this explicit provision, that VALIC's policies are not "insurance contracts." This contention, as shown above, is without basis.

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[7] At the time of the quoted report, the House Bill did not contain the words "annuity contract or optional annuity contract," other than by implication in the reference "and like contracts." Simultaneously the Senate was considering S. 875 which specifically mentioned annuity contracts but did not refer to insurance. The present language, reaching both, was inserted in conference. H.R. 152, 73rd Cong., 1st Sess. (1933).

Neither legislative history nor the circumstances under which the Act was passed supports SEC's contention that Congress intended to foreclose progress by excluding only the then-existing forms of insurance policies and annuity contracts. Very recently the government urged before this Court in *Haynes* v. *United States,* 353 U.S. 82 (1957), that health insurance "should be limited to the particular forms of insurance conventionally made available." The Government argued that the Southern Bell Health Insurance Plan should not be treated as "health insurance" because:

> "The employees paid no fixed periodic premiums, there was no definite fund created to assure payment of the disability benefits, and the amount and duration of the benefit varied with the length of service."

In rejecting this contention this Court stated:

> ". . . The payment of premiums in a fixed amount at regular intervals is not a necessary element of insurance. Similarly there is no necessity for a definite fund set aside to meet the insurer's obligations. And the fact that the amount and duration of benefits increased with the length of time that an employee worked for Southern Bell reflected the added value to the company of extra years of experience and service. . . ."
>
> ". . . There is no support in the legislative history for the Government's argument that Congress intended to restrict the exemption provided . . . . The term 'health insurance' was not defined in any of these acts or in any of the committee reports . . . Under these circumstances we see no reason why the term 'health insurance' . . . should not be given its broad general meaning."

Congress knew that no life insurance policy could be written without both approval and continuing supervision by state insurance authorities. It recognized that "expertise" existed in the insurance departments. Nothing indicates that Congress intended to launch the SEC on insurance regulation.

SEC advances the argument that the Securities Acts "should be read to cover" (Br. 33) the life annuity policies issued by VALIC. Ignoring all state regulation, it contends that there is a "practical need" (SEC Br. 42) for it to intervene to protect VALIC's present or potential policyholders. To support this argument, SEC cites *SEC* v. *Ralston Purina Co.*, 346 U.S. 119 (1953). That case dealt only with the determination of whether an offer of company stock to 500 employees should be exempt (under § 4(1) of the 1933 Act) as not involving a "public offering." In contrast to its detailed definition of "security," the 1933 Act contains no definition of "public offering." In determining Congress' intention in using this vague term, this Court looked to legislative history. It pointed out that the words "not involving any public offering" were added to § 4(1) because such an offering was thought to be one, in the words of the House Report, "where there is no practical need for the [bill's] application." The Court said:

> "Since exempt transactions are those as to which 'there is no practical need for [the bill's] application' the applicability of *Section 4(1)* should turn on whether the particular class of persons affected needs the protection of the Act" (346 U.S. at 125. Words italicized were omitted in SEC's quotation, SEC Br. 39).

The difference, therefore, is between a limited reference to "practical need"—the House Report's words in adding the particular phrase involved in *Ralston-Purina*—to ascertain the meaning of two words descriptive of an exempted transaction and SEC's attempt, on a claim of "need," to extend the whole scope of the Securities and the Investment Company Acts to insurance and annuity policies.

SEC's "need" argument is invalid both on the fact and the law. On the facts, unless SEC can show that the insurance regulation to which VALIC is subject is somehow lacking and that SEC jurisdiction will be more effective in protecting the public interest, SEC fails to substantiate the imagined "need." SEC does not try to make that showing. On the law, the argument of "need" in essence means that Congress did not bring VALIC's policies within the Acts, but this Court should read them in. Here VALIC recalls the language of the Trial Court: "The arguments which plaintiff [SEC] advance here should be addressed to Congress" (R. 91).

The definitions of "security" in the Securities Act (§ 2(1)) and the Investment Company Act (§ 2(a)(35)) are identical. The definition in the Securities and Exchange Act of 1934 (Section 3(a)(10)) is substantially the same. VALIC's life annuity contracts cannot be "securities" under one Act without being "securities" under all.

But SEC never mentions the 1934 Act or claims that it "should be read to cover" VALIC's contracts. Perhaps the reason is that the obvious inapplicability to VALIC's insurance activities of the regulatory scheme of the 1934 Act reinforces the inapplicability of the other Acts.

If variable annuities are "securities," all insurance agents[8] who sell them must register with the SEC as "brokers" under § 15 of the 1934 Act and comply with the many SEC rules, and file the many forms and reports, which were designed for "securities" brokers—e.g., Form BD pursuant to Rule X-15B-1; Rule X-15B-8 requiring a statement of financial condition showing "securities of such broker . . . listed in a separate schedule and valued at the market"; Rule X-17A-3 requiring every such broker (insurance agent) to keep current eleven separate categories of books and records, including a "securities record or ledger reflecting separately for each security . . . all 'long' or 'short' positions"; and Rule X-17A-5, which would require every such agent to file a lengthy annual report on a form the items of which are appropriate to the business of securities brokers and dealers.

If variable annuities are "securities" all insurance agents selling them must accordingly attempt to thread their way through a maze of provisions to determine which, if any, may be deemed by SEC to be "needed," and hence to be within the category which "should be read" to reach their activities.

It is particularly to be noted that the 1934 Act contains no exemption of insurance policies and annuity contracts, as does Section 3(a)(8) of the 1933 Act—so that the 1934 Act poses squarely the question whether insurance policies and annuity contracts come within the term "securities."

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[8] In 1955 there were 189,600 full-time life insurance agents in the United States. 1956 LIFE INSURANCE FACT BOOK, Ct. Ex. 1, p. 49.

IV

VALIC IS NOT AN "INVESTMENT COMPANY" UNDER THE INVESTMENT COMPANY ACT OF 1940

No company can be an "investment company" under the 1940 Act unless it is an "issuer" of "securities" (§ 3(a) and 2(a)(21)). Hence for SEC to extend its jurisdiction to VALIC under this Act, SEC first must establish that VALIC's policies are "securities." For the reasons already set forth, SEC has failed to make this showing.

No company can be an "investment company" under the 1940 Act if it is an "insurance company" (id. § 3(c)(3)). Under this explicit exclusion, an insurance company never comes within the Act of 1940 at all, and hence does not require "exemption." "Exemptions" are provided by § 6 for various companies that are included in the definition of "investment company."

SEC is in error, therefore, in stating that VALIC and EALIC "are non-exempt investment companies" (Heading, SEC Br. 48), and that they "fall technically outside the exemption for insurance companies" (SEC Br. 51). SEC's use of the word "technically" indicates the kind of narrow interpretation SEC would like to give to an "exemption," if only it could show that insurance companies were under the necessity of bringing themselves within one.

VALIC meets precisely the definition of "insurance company" in § 2(a)(17) of the 1940 Act, and hence is excluded from that Act:

(1) VALIC is organized as an insurance company (F. F. 3, 5, 6, 8, 9, 11, 13, 15, R. 94-98);

(2) VALIC's sole, and hence its "primary and preponderant," business activity is the sale and servicing

of insurance contracts, including life insurance, disability insurance, and variable life annuities (F. F. 4, 15, 25, 27, 30, 31, 32, 33, 34, 38, R. 95, 98-104, 106);[9]

(3) VALIC is subject to the supervision of the District Insurance Superintendent and the Insurance Departments of West Virginia, Kentucky, Arkansas (F. F. 6, 8, 9, 15, 19, 20, 21, R. 96-98) and since the trial Alabama and New Mexico (App. II and III, pp. 6a and 7a).

Legislative history demonstrates conclusively that Congress did not intend by the Investment Company Act of 1940 to extend SEC jurisdiction to the activities of regulated life insurance companies.

VALIC agrees that "The Investment Company Act of 1940 was enacted to deal with the problems pointed out" in SEC's Reports on Investment Trusts and Investment Companies (SEC Br. 27). These studies were made over a period of years pursuant to the mandate of § 30 of the Public Utility Holding Company Act of 1935 (15 U.S.C. 792-4).

The initial volume of the resulting SEC studies was transmitted to the Senate and House on June 10, 1938. This part "treated of the origin, scope and conduct of the study."[10] This Classification Report recognized "the breadth of the legislative mandate" (p. 1) and

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[9] NASD (Br. 22) concedes that "The primary business conducted by respondents is selling 'variable annuities' to the public." With typical lack of consistency, NASD also says (Br. 30): "Investing and trading in securities is their principal business . . ." The facts sustain the former, not the latter, view of VALIC's activities.

[10] Investment Trusts and Investment Companies, SEC Report, "The Nature, Classification and Origins of Investment Trusts and Investment Companies," H.R. Doc. No. 707, 75th Cong., (1938), p. iii. This volume is cited hereafter "Classification Report."

indicated the thoroughness of the study. It said on its first page:

> "The major portion of the Commission's time and effort in connection with the study was devoted to investment companies of the management type, companies which have no restriction or only limited restrictions on the investments which they make."

This alone would have excluded life insurance companies, whose investments were and are restricted and controlled by state insurance statutes and state insurance commissioners. But the exclusion was explicit:

> "Although banks and trust companies and insurance companies and similar organizations own securities of other corporations, they were not included in the study because their main and primary business is banking and insurance, respectively and not ownership of securities."[1]

Thus, at the very inception, SEC recognized that the "main and primary"—compare Investment Company Act of 1940, § 2(a)(17), "primary and preponderant"—business of insurance companies was not the ownership of securities, but the sale of policies and the payment of benefits thereunder.

The investment companies under study had flowered in the period 1921-1926, their formation being "materially facilitated by the virtual absence of statutory restraint or governmental regulation or supervision. . . . Unlike banks, insurance companies, and trust funds, the new investment vehicle enjoyed almost complete freedom from any protective restrictions."[2]

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[1] Classification Report, pp. 15-16. The exclusion explicitly extended to life insurance companies. Id. p. 33, fn. 30.

[2] Id. p. 63.

With insurance companies, banks, and similar regulated financial institutions excluded from its scope, the study of "Companies Sponsoring Installment Investment Plans," so freely quoted by SEC, is placed in perspective. That Report was transmitted by SEC in September, 1939. At that date, SEC also had in progress its study of legal reserve life insurance companies looking to the submission ten months later of the report which became TNEC MONOGRAPH 28, and which recommended the development of life insurance techniques to broaden industry investment in common stocks.

In this factual setting, SEC's circuity of argument emerges. SEC says that one abuse which led to the Investment Company Act of 1940 was the fact that unregulated investment trusts attempted to give the impression that they were "similar to savings bank thrift plans or insurance endowment plans" (SEC Br. 24). Now SEC tries to reverse the argument. Since investment trusts in the 1930's tried to look like insurance companies, SEC tries to find in VALIC's insurance policies some similar features that (SEC says) look like what the investment trust tried to look like. Hence, SEC says that VALIC is an investment trust.

What is said by SEC of VALIC, of course, can be said about any life insurance company issuing life annuities which offer equitable participation in the investment results of the companies. We have seen that during the 1930's certain legal reserve life insurance companies, by reducing their guaranteed annuity payments to ultra-conservative levels and supplementing those payments by participations, issued what were in essence variable annuities. That this was known by SEC in 1938, 1939, and 1940, when it was working on

studies of investment trust and on the Investment Company Act, has been conclusively demonstrated. TNEC MON. 28, p. 332, transmitted by SEC to TNEC on July 24, 1940.

Life insurance companies traditionally have written retirement annuities as savings devices offering a lifetime income and, during the premium payment period, a reserve of value which could if necessary be used for education of children, business opportunities, or other family purposes. They have made clear that their assets are invested under state insurance laws in widely diversified securities, and mutual life insurance companies or stock life insurance companies issuing participating policies, have publicized the fact that experience demonstrated that "dividends" deriving from investment results would reduce net premium cost and increase retirement annuity payments. Yet there has never, until now, been any claim that such legal reserve life annuity contracts were "interests sold" (SEC Br. 37, fn); and not even now does SEC claim they are "securities."

SEC also quotes from Senate Report No. 1775, 76th Cong., 3d Sess. (1940). It omits, however, quotation of the pertinent statement therein (pp. 12-13), under "Analysis of Provisions of Title I":

> ". . . Provision is made generally to exclude from the bill . . . insurance companies. . . ."

It certainly was not the intent of Congress by the 1940 Act to superimpose federal on top of state insurance regulation. The following exchange (86 Cong. Rec. 10071), in August 1940, between Senator Wagner, sponsor of the bill and Senator Byrnes, is significant:

"Mr. Byrnes: Mr. President, the bill has nothing to do with the regulation of insurance companies?

"Mr. Wagner: Of course not."

The draftsmen of the Act specifically excluded insurance companies. Thus, David Schenker, Chief Counsel for SEC, testified in April, 1940:

> "There we go on to say any bank or insurance company is exempt, and we have to make that specific exemption because fire-insurance companies invest and reinvest in securities, as do also insurance companies and banks." Hearings before Subcommittee of the Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess., pp. 176-177 (1940); repeated, Hearings before Sub-Committee on Interstate and Foreign Commerce (June, 1940) H.R. 10065, *supra*, p. 102.

A contemporaneous study noted that "while investment companies bear a close resemblance to savings banks and insurance companies, . . . yet legislative curbs comparable to the plethora of regulations which surrounds banks and insurance companies have never been imposed upon investment companies."[3]

Since 1940 there has been no decision even suggesting that a regulated life insurance company could be brought within the Investment Company Act. SEC cites (Br. 50 fn) *Bankers Securities Corp.* v. *S.E.C.*, 146 F. 2d 88 (3d Cir., 1944), apparently hoping to draw sustenance from an incomplete fact statement and one sentence lifted out of context. The title of

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[3] Note "The Investment Company Act of 1940" 41 Columbia L. Rev. 269, 274 (1941). The note adds (277):

> "Likewise organizations which like . . . insurance companies . . . are already subject to adequate governmental supervision . . . are not deemed investment companies within the meaning of the Act."

the defendant company in that case is the cue: Bankers Securities was organized as an investment company for the stated purpose of purchasing, selling and trading in securities. It operated under provisions of the Federal Tax Laws applicable to dealers in securities "held for purposes of resale and not for investment" (146 F. 2d at 90). Obviously, it was an "investment company" under the 1940 Act.

SEC ignores, however, its own decision in *Matter of Aeronautic and Automotive Insurance Agency, Inc.*, 17 SEC 718 (1944). The A & A Agency, an Illinois corporation, operated under a certificate of the Illinois State Director of Insurance pursuant to the Illinois Insurance Code. SEC held that the A & A Agency was not an "investment company" under the 1940 Act, because it was primarily engaged in the insurance brokerage business. SEC's findings conclude:

> "The evidence indicates that the applicant was not organized as an investment company but that it was incorporated to act as an attorney-in-fact for a reciprocal insurance company and to carry on a general insurance and brokerage agency business. Furthermore, the record supports the conclusion that the applicant's investments in the exchange were made for the sole purpose of qualifying the exchange to write contracts and were wholly necessary and incidental to the furtherance and successful prosecution of the applicant's insurance brokerage business. This conclusion is strengthened by the fact that the applicant's principal revenue will consist of a percentage of the premium payments collected by the applicant on insurance contracts written by it rather than income by way of interest payments on the guaranty fund certificates held by it."

Here, of course, VALIC meets every test which SEC in 1944 deemed crucial: VALIC is not organized

as an investment company but as an insurance company to carry on an insurance business. Its stockholders have purchased its stock and contributed to its surplus solely to qualify to write approved insurance contracts. Its basic capital and surplus, represented in part by over $200,000 on deposit with the Superintendent of Insurance, was wholly necessary and incidental to the successful prosecution of its insurance business. Its principal revenue obviously will consist of a percentage of the premium payments on its insurance policies. In short, on objective application of SEC's own criteria, VALIC is not an "investment company."

CONCLUSION

Both petitioners have blinded themselves to two fundamental facts:

A. The mortality guarantee which pools and distributes the life contingency risks of the annuitants—a pure insurance function alien to every concept of a security.

and

B. The effective, detailed supervision of the Insurance Superintendent, under the District Life Insurance Act, and the Insurance Departments of West Virginia, Arkansas, Kentucky, Alabama and New Mexico, afford to VALIC, its policyholders, and the public the fullest of protection.

When these two vital factors are placed in their necessary and proper context in this controversy, it is clear that the judgment of the trial court, affirmed by the Court of Appeals, was correct.

Accordingly, it is respectfully submitted that the judgment of the Court of Appeals should be affirmed on the grounds:

(1) that the variable annuity offered by VALIC is an annuity;

(2) that VALIC is engaged in the "business of insurance";

(3) that VALIC's variable annuity is not a "security" as that term is defined in § 2(1) of the Securities Act of 1933, and, in any event, is exempt from registration under § 3(a)(8) of that Act; and

(4) that VALIC is not an "investment company" as that term is defined in § 3(a) of the Investment Company Act of 1940, and, in any event, is exempt from registration under § 3(c)(3) of that Act.

Respectfully submitted,

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APPENDIX I

Citations to the Insurance Codes of the States and Territories and regulation of annuities by the state insurance commissioners

ALABAMA: Title 28 "Insurance" of the Code of Alabama, 1940 (and supplements), Sec. 4.

ALASKA: Title 42 "Insurance" of the Alaska Compiled Laws, Annotated, Secs. 42-1-3, 42-1-4, and 42-1-5.

ARIZONA: Title 61 "Insurance" of the Arizona Revised Statutes, Annotated, (1956), 1958 Cumulative Pocket Part), Secs. 61-101 and 61-102.

ARKANSAS: Title 66 "Insurance" of the Arkansas Statutes (1947) Annotated, official edition (1957 Replacement), Sec. 66-201.

CALIFORNIA: "Insurance Code" (2 Volumes), West's Annotated California Code, 1955 edition, Secs. 22 and 101.

COLORADO: Chapter 72 "Insurance", of the Colorado Revised Statutes (1953), 1957 Cumulative Supplement, Sec. 72-1-41. See also Sec. 72-6-6.

CONNECTICUT: Title XLII "Insurance" of the General Statutes of Connecticut, Revised edition of 1949), Sec. 6144.

DELAWARE: Title 18 "Insurance" of the Delaware Code, Annotated, 1953, with Supplements, Secs. 18-101, 18-903. See also Sec. 18-915.

DISTRICT OF COLUMBIA: Title 35 "Insurance", District of Columbia Code, 1951 edition (and Supplement), Chapters 3 to 8, inclusive.

FLORIDA: Title XXXV "Insurance", Florida Statutes Annotated, Sec. 625.01.

GEORGIA: Title 56 "Insurance" of the Code of Georgia, Annotated with Annual Pocket Parts (1955), Sec. 56-901 and 56-906.

HAWAII: Chapter 181 "The Hawaii Insurance Law" of the Hawaii Code of Laws, Secs. 181-6, 181-7. See also, 181-533, 534, 535, 536, 537, 538, 540, 541, 542, 544 and 643(h).

IDAHO: Title 41 "Insurance" of the Idaho Code (1948), with 1957 Cumulative Supplement, Sec. 41-201 and 41-304.

ILLINOIS: Title 73 "Insurance" of the Illinois Revised Statutes, 1953, and Supplements (also, Smith-Hurd Illinois Annotated Statutes, 1957 Supplement), Sec. 73-616, par. 4. See also Sec. 73-835, 836 and 839.

INDIANA: Title 39 "Insurance" of the Burns Indiana Statutes (Annotated), 1952 Replacement, Secs. 39-3203 and 39-3501.

IOWA: Title XX "Insurance" of the Iowa Code Annotated, 1949 (with 1958 Supplement), Sec. 508.31.

KANSAS: Chapter 40 "Insurance" of the General Statutes of Kansas, Annotated, 1949, and supplements, Sec. 40-401.

KENTUCKY: Chapter 304 "Insurance" of the Kentucky Revised Statutes, official edition, 1953, with supplements, Secs. 304.340 and 304.801.

LOUISIANA: Title 22 "Insurance Code" of the Louisiana Revised Statutes (1950) with 1957 Supplement Secs. 22:5 and 22:6. See also Secs. 22-163, 168, 172, 173, 174, 643, 647, 1061, 1062 and 1214.

MAINE: Chapter 60 "Insurance and Insurance Companies", of the Revised Statutes of Maine, 1954 edition (1957 cumulative supplement), Secs. 1, 170. See also, Sec. 139 and 140.

MARYLAND: Article 48A "Insurance" of the Annotated Code of Maryland (1957), Sec. 152.

MASSACHUSETTS: Title 22, chapters 174A and 175 "Insurance" of the General Laws of Massachusetts, Secs. 118 and 119. See also, Secs. 182, 183 and 184.

MICHIGAN: Title 24 "Insurance" of the Michigan Statutes Annotated (1957), Revised Volume, Secs. 24.1602.

MINNESOTA: Chapter 60 "Insurance Division" of the Minnesota Statutes (Annotated), Sec. 60.29 sub-paragraph (4).

MISSISSIPPI: Title 22 "Insurance" of the Mississippi Code, 1942, Recompiled (1957), Sec. 5654 and 5680.

MISSOURI: Title XXIV "Insurance" of Vernon's Annotated Missouri Statutes (1952) and 1958 Supplement (vol. 19), Sec. 376.010.

MONTANA: Title 40 "Insurance and Insurance Companies" of the Revised Code of Montana, 1947, Annotated (1957 Supplement), Secs. 40-101, 105, 1001, 1905.

NEBRASKA: Chapter 44 "Insurance" of the Revised Statutes of Nebraska, Revision of 1952, with 1958 Supplements, Secs. 44-201, 44-404.

NEVADA: Title 57 "Insurance and Insurance Companies", of the Nevada Revised Statutes (vol. 5), Sec. 681.020.

NEW HAMPSHIRE: Title XXXVII "Insurance" of the New Hampshire Statutes Annotated, 1955, Sec. 401.1.

NEW JERSEY: Title 17, subtitle 3 "Insurance" of the New Jersey Statutes Annotated, Permanent edition, with 1958 supplement, Sec. 17-1(c) and (e).

NEW MEXICO: Chapter 58 "Insurance" of the New Mexico Statutes Annotated, 1953, Secs. 58-1-1 and 58-7-1.

NEW YORK: "Insurance Law", of McKinney's Consolidated Laws of New York Annotated, vols. 27 and 28 (1949), with 1958 cumulative annual pocket supplement, Sec. 46, par. (4).

NORTH CAROLINA: Title 58 "Insurance" of the General Statutes of North Carolina, Secs. 58.195 and 58.72.

NORTH DAKOTA: Title 26 "Insurance" of the North Dakota Revised Code of 1943, Secs. 26-0201, 26-0501 and 26-0344. See also, Sec. 26-0802.

OHIO: Title 39 "Insurance" of the Baldwin's Ohio Revised Code, 1953, Annotated edition with supplement (also, Page's Ohio Revised Code, Annotated), Sec. 3907.01.

OKLAHOMA: Title 36 "Insurance" of the Oklahoma Statutes Annotated, permanent edition (1958), Sec. 702. See also, Secs. 4001-4029, inclusive.

OREGON: Title 56 "Insurance and Insurance Companies" of the Oregon Revised Statutes (1957 Replacement), Sec. 739.005.

PENNSYLVANIA: Title 40 "Insurance", of Purdon's Pennsylvania Statutes Annotated, Permanent Edition (1954), Sec. 382, 477(b) and 551.

RHODE ISLAND: Title 29 "Insurance" of the General Laws of Rhode Island, Sec. 29-4-12, 47-4-13.

SOUTH CAROLINA: Title 37 "Insurance" of the Code of Laws of South Carolina (1952), Secs. 3, 142.

SOUTH DAKOTA: Title 31 "Insurance" of the South Dakota Code, Secs. 31-0101, 31-2218, 31-1603 and chapter 57.35A "Insurance Premiums and Annuity Contracts".

TENNESSEE: Title 56 "Insurance" of the Tennessee Code (1955), Sec. 56-206.

TEXAS: Vol. 14 "Insurance Code" of Vernon's Texas Civil Statutes, Annotated (1952), Article 3.01.

UTAH: Title 31 "Insurance" of the Utah Code Annotated (1953 Supplement) Sec. 31-11-2.

VERMONT: Chapters 387-394 "Insurance" of the Vermont Statutes, Revised Edition, Sec. 9023.

VIRGINIA: Title 38 "Insurance" of the Code of Virginia (1950), Sec. 31-1-2.

VIRGIN ISLANDS: Title 22 "Insurance" of the Virgin Islands Code (1957), Sec. 3.

WASHINGTON: Title 48 "Insurance" of the Revised Code of Washington, Sec. 48.23.010, et seq,, "Life Insurance and Annuities", and Sec. 48.24, et seq., "Group Life and Annuities".

WEST VIRGINIA: Chapter 33 "Insurance and Annuity Contracts" of the West Virginia Code of 1949 (Annotated), with supplement, Sec. 3332.

WISCONSIN: Chapters 200-210 "Insurance" of the Wisconsin Statutes (1953), Sec. 201.04.

WYOMING: Title 52 "Insurance" of the Wyoming Compiled Statutes, Sec. 52-501.

APPENDIX II

(p. 6a)

(Face of Certificate)

CERTIFICATE OF AUTHORITY

DEPARTMENT OF INSURANCE — STATE OF ALABAMA

I, THE UNDERSIGNED, SUPERINTENDENT OF INSURANCE OF THE STATE OF ALABAMA, BY AUTHORITY VESTED IN ME BY LAW DO HEREBY AUTHORIZE THE LICENSEE NAMED BELOW TO ACT WITH POWERS INDICATED HEREON.

THIS CERTIFICATE EXPIRES DECEMBER 31 FOLLOWING THE EFFECTIVE DATE SHOWN BELOW UNLESS SUSPENDED OR REVOKED PRIOR THERETO.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, WASHINGTON, D. C.

COMPANY	EFFECTIVE DATE			POWER
2000	11	1	58	1
LICENSE NO.	MO.	DAY	YR.	OVER

SUPERINTENDENT OF INSURANCE

(Back of Certificate)

COMPANY POWERS

1. Life, Health, Accident, and Hospitalization
2. Fire and Allied Lines
3. Miscellaneous Casualty, excluding Official Surety Bonds
4. Miscellaneous Casualty, including Official Surety Bonds
5. Mutual Aid
6. Fraternal Benefit Societies
7. Non-Profit Hospital, Medical and Surgical
8. Reciprocal Exchange

APPENDIX III

State Corporation Commission
of New Mexico
Insurance Department

No. 216 **1958**

INSURANCE COMPANY LICENSE

It Is Hereby Certified, *That the* VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA *a corporation organized under the laws of* DISTRICT OF COLUMBIA *whose principal office is located at* WASHINGTON, D. C. *has complied with the requirements of the laws of this State applicable to said Company and is hereby authorized to transact the business of*

CLASS 1, LIFE, ACCIDENT AND HEALTH

(SEE REVERSE SIDE)

Insurance in accordance with its Charter or Certificate of Incorporation within

STATE OF NORTH DAKOTA

No. 6815

OFFICE OF THE COMMISSIONER OF INSURANCE

CERTIFICATE OF AUTHORITY

WHEREAS, The EQUITY ANNUITY LIFE INSURANCE COMPANY

a Corporation organized under the Laws of DISTRICT OF COLUMBIA
has filed in this office a sworn statement exhibiting its condition and business for the year ending December 31, 19 57.
conformable to the requirements of the Laws of this State regulating the business of insurance; and

WHEREAS, the said corporation has filed in this office a duly certified copy of its charter with certificate of organization in compliance with the requirements of the Insurance Laws aforesaid:

NOW, THEREFORE I, A. J. JENSEN, Commissioner of Insurance of the State of North Dakota, pursuant to the provisions of said Laws, do hereby certify that the above named corporation is fully empowered through its authorized agents to transact its appropriate business of

LIFE AND ANNUITIES ONLY

Insurance in this State, according to the Laws thereof, until the 30th day of April 19 59

IN TESTIMONY WHEREOF, I have hereunto set my hand and seal at Bismarck,
this 1st day of May 19 58

A. J. JENSEN Commissioner of Insurance.

By _____ Deputy

Buy "Dakota Maid" Flour

APPENDIX V

POLICY ENDORSEMENT

Provision 18 of this policy is modified by deleting the following phraseology:

> ". . . and less the sum of federal income taxes and other taxes, if such other taxes are measured by investment income and capital gains and losses, realized or unrealized, or either of them, accrued on policies of this class. . . ."

The purpose of this modification is to provide that federal income taxes and other taxes measured by investment income and capital gains and losses, realized or unrealized, levied against the Company shall not be considered in determining the total investment experience of the Company each month.

/s/

President
Variable Annuity Life Insurance Company of America

DA-1000-El

APPENDIX VI

Disclosure Requirements and Penalties for Misrepresentation Under the District of Columbia Code, Title 35 Insurance

§ 35-103. *Annual Statements—Statement to be published in newspaper.*

The said superintendent shall furnish, in December of each year, to every insurance company or association, local, domestic, and foreign, doing business in the District of Columbia, or its agent or attorney in the District, the necessary blank forms for the annual statements for such company or association, which shall be returned to the superintendent on or before the first day of March in each year, signed and sworn to by the president or vice-president and secretary or assistant secretary, or, if a foreign company, by its manager or proper representative within the United States, showing its true financial condition as of the next preceding 31st day of December, which shall include a statement of its assets and liabilities classified according to regulations made by the Superintendent of Insurance on that day, the amount and character of business transacted, losses sustained, and money received and expended during the year, and such other information as the said superintendent may deem necessary. Such annual statements shall be printed in at least one daily newspaper published in the District of Columbia, in the month of March in each year; and any such company or association failing to comply with the provisions aforesaid shall have its license to do business in the District revoked.

§ 35-106. *Superintendent to make annual report.*

The Superintendent of Insurance shall report annually to the commissioners of the District, on or before the thirty-first day of March, the financial condition of each insurance company and association doing business in said District, as of the thirty-first day of December next preceding.

§ 35-107. *Superintendent's reports to be bound.*

After May 18, 1910, the annual reports of the Superintendent of Insurance shall be printed and bound in one volume, and shall be ready for distribution not later than the first day of the next regular session of Congress thereafter.

§ 35-204. *Principal office to be in District of Columbia—Keeping and removing of records . . . .*

Any corporation now or hereafter formed or organized under any provision of law in force and effect in the District of Columbia to engage in an insurance business shall maintain its principal office within said District and shall keep its books, records, and files therein, and shall not remove from said District either its principal office or its books, records, or files without the permission of the Commissioners of the District of Columbia first had and obtained: . . :

§ 35-407. *Annual statement—Verification—Failure to make.*

Every company doing business in the District shall file with the superintendent before March 1 in each year a financial statement for the year ending December 31, immediately preceding, on forms furnished by the superintendent. Such statement shall be verified by the oaths of the president and secretary of the company, or, in their absence by two other principal officers. The statement of an alien company shall embrace only its condition and transactions in the United States and shall be verified by the oath of its resident manager or principal representative in the United States. In case a company shall fail to make and file its annual statement within the time herein prescribed its authority to transact business in the District shall thereupon terminate. (June 19, 1934, 48 Stat. 1132, ch. 672, § 8, ch. II)

§ 35-408. *Penalty for false statement.*

A director, officer, agent, or employee of any company who wilfully and knowingly subscribes, makes, or concurs in making or publishing any annual or other statement required by law, containing any material statement which is false, shall, upon conviction thereof, be punished by imprisonment in the penitentiary for not less than two nor more than ten years. A person who wilfully and knowingly makes oath to any such false statement shall be guilty of perjury. (June 19, 1934, 48 Stat. 1132, ch. 672, § 9, ch. II.)

§ 35-418. *Examinations—Reports—Verification—Hearing upon—Publication—Expense.*

The superintendent may examine the books, papers, property, and the affairs of any insurance company organized or doing business in the District and of any company engaged in or professing to be engaged in organizing, promoting, or soliciting stock or capital contributions to or aiding in the formation of an insurance company or of any company which holds the capital stock of an insurance company for the purpose of controlling the management thereof as voting trustees or otherwise. The superintendent, his deputy, or any examiner may examine under oath the officers and agents of such company and all persons deemed to have material information regarding the company's property or business.

* * * * * * * * * *

The superintendent shall grant a hearing to the company examined, or he shall furnish it a copy of his report, in tentative form, requesting that the statements and items therein contained be checked, and the report be returned to the superintendent within the time specified by him, before filing any such report and before making public such report or any matters relating thereto; and may withhold any such report from public inspection for such

time as he may deem proper; and may after so filing, if he deems it for the interest of the public to do so, publish any such report or the result of any such examination as contained therein in one or more newspapers in the District without expense to the company. It shall be the duty of the superintendent to examine every domestic insurance company at least once in three years.

The expense of every such examination, not to include salaries, shall be paid by the company examined, and such company shall pay to the superintendent, his deputies, and/or his examiners the actual expense of such examination upon itemized bills furnished by the superintendent. (June 19, 1934, 48 Stat. 1135, ch. 672, § 19, ch. II.)

§ 35-530. *Officers and directors not to be pecuniarily interested in transactions . . .*

No director or officer of any company doing business in the District shall receive any money or valuable thing for negotiating, procuring, recommending, or aiding in any purchase by or sale to such company of any property, or any loan from such company, nor be pecuniarily interested, either as principal, coprincipal, agent, or beneficiary, in any such purchase, sale, or loan, nor shall the financial obligation of any such director or officer be guaranteed by such company in any capacity: . . . (June 19, 1934, 48 Stat. 1151, ch. 672, § 30, ch. III)

§ 35-714. *Misrepresentations prohibited.*

No life company doing business in the District, and no officer, director, general agent, agent, or solicitor thereof, broker, or any other person shall make, issue, or circulate, or cause to be issued or circulated, any estimate, illustration, circular, or statement of any sort misrepresenting the terms of any policy issued or to be issued by it or the benefits or advantages promised thereby, or the dividends or shares of the surplus to be received thereon, or shall use any name or title of any policy or class of policies mis-

a corporation organized under the laws of DISTRICT OF COLUMBIA

whose principal office is located at WASHINGTON, D. C.

has complied with the requirements of the laws of this State applicable to said Company and is hereby authorized to transact the business of

CLASS 1, LIFE, ACCIDENT AND HEALTH

(SEE REVERSE SIDE)

Insurance in accordance with its Charter or Certificate of Incorporation within the State of New Mexico, subject to the provisions and requirements of law until the last day of February in the year of our Lord one thousand nine hundred and fifty-nine.

In Witness Whereof, *The Superintendent of Insurance of the State of New Mexico has caused this license to be signed and the seal of said Superintendent to be affixed hereto at the city of Santa Fe, this* 31ST *day of* DECEMBER *A.D., 1958*

SUPERINTENDENT OF INSURANCE

11

representing the true nature thereof. Nor shall any such corporation or officer, director, general agent, agent, or solicitor thereof, broker or any other person, firm, association, or corporation make any misrepresentation to any person insured in any company for the purpose of inducing or tending to induce a policyholder in any company to lapse, forfeit, or surrender his insurance. It shall be the duty of the superintendent, upon due proof after notice and hearing that any such company or agent thereof has violated any of the provisions of this section, to revoke the authority of the company or agent so offending: *Provided, however,* That the action of the superintendent in this regard shall be subject to appeal and review in the form and manner prescribed in section 35-427. (June 19, 1934, 48 Stat. 1174, ch. 672, § 14, ch. V.)

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IN THE

Supreme Court of the United States

OCTOBER TERM 1958

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,

Petitioner,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA,

and

THE EQUITY ANNUITY LIFE INSURANCE COMPANY,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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Of counsel:
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ROMAN TIMES LAW PRINTERS

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IN THE

Supreme Court of the United States

OCTOBER TERM 1958

No. .....

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,

Petitioner,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA,

and

THE EQUITY ANNUITY LIFE INSURANCE COMPANY,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

National Association of Securities Dealers, Inc. (NASD), prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit, entered in the above-entitled case on May 22, 1958.

Citation to Opinions Below

The opinion of the District Court (R. 82) is reported in 155 F. Supp. 521. The opinion of the Court of Appeals (R. 885), printed in Appendix B hereto, *infra,* p. 31, is reported in F. 2d .

Jurisdiction

The judgment of the Court of Appeals was entered on May 22, 1958 (R. 895) and is printed in Appendix B hereto, *infra,* p. 40. The jurisdiction of this Court is invoked under 28 U. S. C. § 1254 (1).

Question Presented

Whether "variable annuity" contracts within the definition of "security" as defined in § 2(1) of the Securities Act of 1933; and whether the issuers of such contracts within the definition of "Issuer" in § 2(a) (21) of the Investment Company Act of 1940, are exempted from compliance with the provisions of said Federal statutes because the "Issuer" is: (a) chartered by a state or the District of Columbia as an insurance company; and, (b) a State or District of Columbia administrative officer or agency declares that the contracts are "insurance" notwithstanding that the contracts do not possess what this Court has held are "elements * * * essential to a life insurance contract * * *."

Statutes Involved

Statutes involved are the Securities Act of 1933 (Act of May 27, 1933, 48 Stat. 74, as amended, 15 U. S. C. § 77a); the Investment Company Act of 1940 (Act of August 22, 1940, 54 Stat. 789, 15 U. S. C. § 80a-1) and the McCarran-Fer-

guson Act (Act of March 9, 1945, 59 Stat. 33, as amended, 15 U. S. C. §§ 1011-1015). Pertinent provisions of these statutes are printed in Appendix A hereto, *infra*, p. 18.

Statement

This action was instituted by the Securities and Exchange Commission (SEC) to enjoin Variable Annuity Life Insurance Company of America (VALIC) from violating the registration provisions of the Securities Act[1] and the Investment Company Act.[2] The District Court had jurisdiction of the action by virtue of § 22(a) of the Securities Act of 1933 (15 U. S. C. § 77v(a)) and § 44 of the Investment Company Act of 1940 (15 U. S. C. § 80a-43). On their own motions NASD, petitioner herein, and the Equity Annuity Life Insurance Company (EALIC) intervened on the sides of the plaintiff and defendant, respectively. The NASD is a duly organized national securities association registered with the SEC (5 S. E. C. 627 (1939)) having and administering powers in the over-the-counter securities market conferred by § 15A of the Securities Exchange Act of 1934, as amended.[3] VALIC and EALIC alleged as affirmative defenses § 3(a)(8) of the Securities Act exempting insurance and annuity contracts (15 U. S. C. § 77c(a)(8)); §§ 2(a)(17) and 3(c)(3) of the Investment Company Act exempting insurance companies (15 U. S. C. §§ 80a-2(a)(17) and 80a-3(c)(3)); and, lack of SEC authority because of the provisions of the McCarran-Ferguson Act (15 U. S. C. §§ 1011-1015). The material facts (R. 115-299) are not in dispute and may be summarized as follows:

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[1] Sections 5(a)(1) and 5(c) of the Securities Act of 1933, 15 U. S. C. §§ 77e(a)(1) and 77e(c).

[2] Section 7 of the Investment Company Act of 1940, 15 U. S. C. § 80a-7.

[3] Act of June 6, 1934, 48 Stat. 881, as augmented by Act of June 25, 1938, § 1, 52 Stat. 1070, 15 U. S. C. §78o-3.

VALIC and EALIC are chartered as stock insurance companies in the District of Columbia. Their principal business is the sale of contracts labeled with the coined name "variable annuity."[1] This novel contract first came into being in 1952 (R. 490).

The purchaser of a variable annuity contract, whom we shall refer to as the investor (referred to in the contract as the "annuitant"), agrees to make certain specified periodic payments to VALIC during a stipulated period from ages 0 to 70 years.[2] After deducting loading charges for expenses and profits the net remaining from each payment is invested by VALIC in an investment fund, consisting almost exclusively of common stocks, for the account of the investor. This fund is exclusively managed, controlled and operated by VALIC, the promoter. At the time of each payment the investor is credited with a number of shares in the fund (referred to in the contract as "accumulation units"), determined by dividing the current value of shares at the time of payment into the net payment. The contract provides that each year VALIC shall notify each contract holder of the total number of shares ("accumulation units"), determined by dividing the current value of shares at the date of notification. The value of the shares fluctuates with the promoter's (VALIC's) investment experience. Throughout the period during which the investor is making periodic payments he may, at any time, cash in his shares at current value as a result of which he may realize

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[1] The Court of Appeals found that "although VALIC sells what are undoubtedly life insurance contracts, they are tied in with its 'annuity' contracts and are a small part of its total business." (App. B, p. 34.)

[2] VALIC sells numerous types of contracts involving the same investment principle. The contract (R. 567) herein described is sold by VALIC and is entitled "Deferred Variable Annuity Policy." It was received in evidence as a specimen of all the contracts that employ such investment practice (R. 84). EALIC stipulated that its contracts were in all material respects the same as those issued by VALIC (R. 84).

a profit or loss (this the contract calls "cash value"). The investor may also cash in a portion of his shares at current value (this the contract calls a "policy loan"). However, if he reinvests (repays) what the contract terms a "policy loan" he does not receive the same number of shares he cashed in. Instead, his "repayment" purchases shares at their current value as of the date of "repayment." There is no life contingency involved in this pay-in period. All during this period the elements of a profit-seeking venture are present. The investors provide the capital, share in the earnings and profits, and are saddled with the risk of loss resulting from investment of their funds by the promotor (VALIC).

The contract does not obligate the investor to participate in the investment fund to any further extent than that set forth above. The "variable annuity" contract does, however, give the investor an election to purchase a so-called "variable annuity" between the ages of 50 and 70 years. If he so elects he makes a capital contribution to VALIC equal to the number of shares ("accumulation units") which he has purchased times the then current value of a share.[1] For each $1000 of said contribution he is guaranteed a *first* monthly payment of something less than $10 per thousand paid in, computed on the basis of the Progressive Annuity Mortality Table at 3½% interest. After the first payment he is guaranteed (assured) no specific, *or even any,* monthly payment. Instead, he is credited with a number of shares

[1] From the inception of the contract up to the date of election the investor cannot know what capital he will have acquired for he cannot foresee how many shares ("accumulation units") he will have purchased or their value as of the date of election. VALIC stands legally indifferent whether the value of all shares acquired is at that time less or more than the total amount invested. The investor has only the hope that VALIC's management, operation and control of the investment fund in which he has an aliquot share will result in a profit and not a loss.

(called "annuity units") in the investment fund.[1] The future value of these shares ("annuity units") is speculative in that *all* monthly payments to the investor subsequent to the first are computed by the formula number of shares times the current monthly value of the share resulting from VALIC's operation, management and control of the investment fund. Before the investor's interest is made manifest, VALIC deducts, as prior charges, a management fee (1.8% per annum) and taxes (undescribed in the contract). The investor is paid each month for life or other optional term the uncertain future current monthly value of a share ("annuity unit"), *if any*, times the shares credited to his account. The investor has only the hope of gain and bears the risks of loss. He has no voice in VALIC's management, control or operation of the investment fund, and no control of its resulting investment experience.

Purchasers of the contract are attracted by the expectation of substantial profits. VALIC's sales literature (R. 745-804) describes the scheme as: "* * * a way to provide inflation-proof retirement * * *" (R. 749); a "* * * plan * * * to provide a purchasing power income * * *" (R. 750). The contract contains no guarantees (assurance) of such results; it does not even mention them.[2] Further, the litera-

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[1] "Annuity units" credited to the purchaser's account are determined by dividing the first month's guaranteed payment to him by the current value of such a unit. The number of units remains constant for the balance of the term of the contract. One who elects to purchase a "variable annuity" contract when the value of an "annuity unit" is low will have more such units credited to his account than another making the same capital investment under the same contract when the value of the unit is higher. The former, owning more shares, will receive larger payments than the latter in the same month although each has invested an identical amount of dollars.

[2] EALIC, in a pamphlet entitled "EQUITY ANNUITY—a new road to SECURITY," says:

> "Our variable annuity program is designed to minimize the speculative features of common stock investments. You avoid the gamble of buying a single stock * * * the Company 'spreads the risk' by buying stocks in *many* of the nation's leading corporations * * * You avoid the risk of buying stocks at one point in the stock market * * * You avoid buying stocks on a 'hot tip'. Instead you benefit from the counsel of expert financial advisers * * * In short you get the benefit of expert diversification." (Pls. Exh. 17, not printed in Joint Appendix.)

ture implies that through VALIC's investment management of the fund the investor will receive a greater amount of dollars in return than would a purchaser of an annuity. This the contract does not guarantee. The literature omits to inform of losses which the investor may incur because of possible poor investment management or market fluctuations having no relationship to the costs of living or the purchasing power of the dollar.

The District Court found that:

> "74. A VALIC and an EALIC contract holder invests money with the respective defendants with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased by VALIC and EALIC with the money invested by the contract holder, and his expectation of profit based upon the efforts of others applies to both the 'accumulation period' and to the repayment or variable annuity period" (R. 109-110).
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> "49. The risk of profit or loss on investment is borne by the contract holders" (R. 108).
>
> "94. The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund to be invested mainly in common stocks" (R. 111).

In its opinion the District Court stated that "The logic of the law applied to the established facts seems to bring the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants within the terms and plan of the Investment Company Act" (R. 89). It so found as a conclusion of law (R. 112). Without making a finding that the variable annuity contract is "insurance" and its sale "the business of insurance" the District Court denied the injunction because VALIC and EALIC were chartered as insurance companies and their variable annuity contracts had been approved by the Insurance Superintendent of the District of Columbia and by the insurance

departments of three States (West Virginia, Kentucky and Arkansas). From this premise the Court reasoned that the provisions of the McCarran-Ferguson Act exempted the contract and its sale from compliance with the Federal securities laws (R. 90-91, 112).

The Court of Appeals recognized that:

> "* * * the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last."

It then went on to show that this risk *is not shifted* by the variable annuity contract by saying:

> "The appellants urge that VALIC policy holders, like investors in investment companies, may lose their savings and ultimately fail to receive the protection which they hoped to buy when they paid their premiums. That fact seems to us to be inherent in the nature of this experiment in annuity contracts" (App. B, *infra*, pp. 38-39).

The Court of Appeals refused to apply this Court's determination that when the Congress employed the term "insurance" in a statute without definition it used the word "in its commonly accepted sense" and that:

> "Historically and commonly insurance involves risk-shifting and risk-distributing * * * That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators." *Helvering v. Le Gierse*, 312 U. S. 531, 539-540 (1941).[1]

In affirming the District Court in an opinion unsupported by reference to case law or authorities it failed to find or hold that the variable annuity contract is "insurance" or an "annuity." Instead, it found that the sale of variable annuity contracts is a "new business" which "*resembles* insurance"[2] (App. B, *infra*, p. 39). The Court of Ap-

[1] It also failed to apply a similar test of the indispensable elements of an insurance contract set forth in its opinion in *Jordan v. Group Health Ass'n*, 107 F. 2d 239, 244-5 (D. C. Cir. 1939).

[2] Italics supplied.

peals, paying no heed to the substance of the contracts, attached controlling weight to approval of them by the Superintendent of Insurance for the District of Columbia and insurance commissioners of three states (App. B, *infra*, pp. 37, 39). It disregarded cases cited by SEC and NASD in which the insurance authorities for the states of Connecticut and South Carolina had rejected similar investment schemes as insurance and were sustained by the courts. *Spellacy v. American Life Insurance Association*, 144 Conn. 346, 131 A. 2d 834 (1957); *Coastal States Life Insurance Co. v. Kelly*, Court of Common Pleas, Richland County, S. Car., June 1955, unreported. The Court did not indicate that it had given any consideration to the expert opinion of the SEC that the contracts are securities. It disregarded that recognized leaders in the insurance industry are divided on the question as to whether variable annuity contracts are insurance and a proper product to be offered by life insurance companies. See, Appendix C hereto, *infra*, p. 42, 1956 Proceedings of the National Association of Insurance Commissioners, Vol. I, pp. 162-165 (Semi-Annual Meeting).[1] Also, that under existing law such contracts cannot qualify as insurance in many states; e.g., New York, New Jersey, Massachusetts. Instead of adjudicating the legal issue presented as to whether the contracts are in substance a "security" or "insurance" the Court supported its conclusion on its predilection that there is an economic demand for such contracts. Thus it overlooked the issues that the pleadings make clear that the objective of the action is to determine whether the offering and sale of such contracts must comply with the Federal securities laws.

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[1] The Uniform Securities Act (Vol. 9C of the Uniform Laws Annotated) recently recommended for adoption by state legislatures defines "Security" (§ 401(l)) "so as not to exclude from the definition the so-called 'variable annuities' which have recently been developed." (Quoted from Commissioners' comment on the section.) See also § 402(a)(5) and the Commissioners' comment thereon.

Reasons for Granting the Writ

This is a case of first impression in the Federal courts. It turns on the proper interpretation and application of three important Federal statutes designed to protect the public, the investor and the public interest. The Court of Appeals did not expressly construe these acts. Its decision in effect leaves their interpretation and application to depend on the administrative conclusions of the 48 state insurance commissioners (plus those of the District of Columbia and the territories) as to whether "variable annuities" are "insurance" or "securities." Unless this Court reviews the decision below, the scope of the Federal securities laws will henceforward depend on the determinations of state officials acting under widely differing state laws.[1]

1. In refusing application of the long established judicial definition of the terms "investment contract" and "certificate of interest or participation in any profit-sharing agreement" as used in § 2(1) of the Securities Act, the ruling of the court below conflicts with the decisions of this Court in *SEC v. C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943) and *SEC v. W. J. Howey Co.*, 328 U. S. 293 (1946).

Disregarding form for substance and emphasizing economic reality, the instant case is not distinguishable in principle from the *Joiner* and *Howey* cases, in which the promoters attempted to disguise investment contracts as leasehold rights and land sales contracts, respectively. This Court has stated that the term "investment contract" "is capable of adaptation to meet the countless and

[1] The exemption from Federal jurisdiction granted in the McCarran-Ferguson Act is limited to "the business of insurance" (App. A, *infra*, p. 29); a phrase, undefined in the Act, which this Court has never construed. The recent cases of *F. T. C. v. National Casualty Co.*, and *American Hospital and Life Insurance Co.*, Nos. 435 and 436, respectively, decided by this Court on June 30, 1958, are inapposite. The issue in those cases was premised on the assumption that respondents were engaged in "the business of insurance." The issue in this case is whether the variable annuity contracts are "insurance" and their issuance and sale "the business of insurance."

variable schemes devised by those who seek the use of the money of others on the promise of profits.'"[1] Also that:

> "'* * * an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Such a definition necessarily underlies this Court's decision in Securities Exch. Commission v. C. M. Joiner Leasing Corp., 320 U. S. 344, and has been enunciated and applied many times by lower federal courts.'"[2]

The transactions in this case clearly involve investment contracts as so defined.

2. This case presents a question of exemption from Federal jurisdiction which has not been but should be settled by this Court. The contracts at issue can be exempted from the congressional mandates of the Securities Act only if they come within the meaning of the terms "insurance * * * or annuity contract" as employed in § 3(a)(8) of the Act. The Act does not define these terms. This Court has said that where "insurance" is used undefined in a statute it must be presumed that "Congress used the word 'insurance' in its commonly accepted sense." In the same case this Court held that "risk-shifting and risk-distributing are essential to a life insurance contract * * *"[3] In failing and refusing to apply these tests the Court of Appeals has disregarded the principles established by this Court. The risk which an insurer takes that it will be financially able to fulfill its contractual obligations to the insureds upon the happening of the specified insurable contingency is not an insurance risk. *Keller v. Commissioner of Internal Revenue,*

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[1] *Howey* case, 328 U. S. at p. 299.

[2] *Howey* case, 328 U. S. at pp. 298-299.

[3] *Helvering v. Le Gierse*, 312 U. S. 531, 539-540.

312 U. S. 543, 544 (1941). An insurance risk is the loss which a person will suffer upon the happening of an insurable contingency; it is that loss which it is *essential* be shifted to the insurer to qualify the contract as insurance. Otherwise stated, if the risk of the loss continues to be vested in the person subject to it, there is no insurance. The risk of loss is not shifted in the variable annuity contract because there is no assurance that the purchaser will have a fixed dependable income, *or any income*, for the remainder of his life. Risk-distribution without risk-shifting cannot be held to be insurance.

The essence of an "annuity," as long established by definition supported by scores of court opinions, is (a) periodic payment of (b) a fixed sum.[1] A typical definition is that set forth in the leading case of *Booth v. Ammerman*, 4 Bradf. Surr. 129, 133, 134 (N. Y. 1856), which has been cited in many decisions:

> "An annuity is a stated sum per annum, payable annually unless otherwise directed. It is not income or profits, nor indeterminate in amount varying according to the income or profits, though a certain fund may be provided, out of which it is to be payable * * * (If a periodic payment) is not a stated sum, but may be more or less, according to the earnings of the capital * * * it does not possess the characteristic of an annuity * * *" (Parenthetical matter supplied).

The Court of Appeals made no finding as to whether the variable annuity contract is "insurance" or an "annuity," a finding which is indispensable to a conclusion of law that the exemptive provision is applicable. It rejected the established principle of statutory construction that words in a statute are used in their commonly ac-

[1] The authorities to this effect have recently been assembled and reviewed at length in connection with "variable annuities." See, Bellinger, *et al.*, "The Meaning and Usage of the Word 'Annuity'," 9 Journal of the American Society of Chartered Life Underwriters 261 (1955).

cepted sense. It abdicated its judicial responsibility to make and enforce an interpretation of existing law. For judicial interpretation and application of the law it substituted administrative opinion which will vary from state to state, including the territories and the District of Columbia, with the personal predilections of each insurance administrator and the non-uniformity of state insurance laws.[1] It would be very strange if, in the absence of an expressed Congressional delegation of authority, the mere declaration by a state administrative officer that a contract is "insurance" were final and binding on the Federal judiciary in its consideration of exemptive provisions of Federal law. Such a view is in conflict with the decision in the *Le Gierse* case, in which this Court found that absent the essential elements of insurance the contracts (a life insurance policy and an annuity contract) were not insurance notwithstanding that, what the facts make clear, the issuer was chartered as an insurance company and the contracts had been approved by a state insurance commissioner. It is also in conflict with the lower court's own decision in *Jordan v. Group Health Ass'n*, 107 F. 2d 239, 244-5 (D. C. Cir. 1939), in which it found that the contract in issue was not "insurance," because it lacked the essential elements of insurance, notwithstanding that the Superintendent of Insurance for the District of Columbia had determined that it was and initiated the action to compel the issuer to comply with the insurance laws of the District of Columbia.[2]

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[1] For its own purposes a state may by statutory enactment include within a definition of "insurance" whatsoever it may choose. Certainly, when the Congress used the term "insurance," undefined, it did not vest the states with the power to grant exemptions from the Securities Act.

[2] In *Drake v. United States ex rel. Bates*, 30 App. D. C. 312 (1908), the Court of Appeals in referring to the powers of the Superintendent of Insurance for the District of Columbia said:

> "It is quite clear that no provision of the law conferred or attempted to confer upon the superintendent of insurance the power to make and enforce an interpretation of the laws relating to insurance companies . . . Such power is a judicial one, that can be exercised by the courts alone." (30 App. D. C. at pp. 318-19.)

3. The decision is in conflict with a decision of the Supreme Court of Errors for the State of Connecticut in which that court determined that a "variable endowment contract" with a "variable annuity option" was not "insurance" or an "annuity." The case was initiated by the Insurance Commissioner to restrain the issuance of the policy by the defendant, which was licensed by the Commissioner to do business in the state. *Spellacy, Insurance Commissioner v. The American Life Insurance Ass'n,* 144 Conn. 346, 131 A. 2d 834 (1957). Concerning the variable annuity scheme the court said:[1]

> "The variable annuity policy is to be issued 'for such total number of variable annuity units, payable monthly or as may be agreed, as the cash redemption value of the accumulated variable endowment units * * * shall purchase at the initial conversion value of the Variable Annuity Units in effect when the [policy] is issued.' A minimum is fixed at 1000, variable annuity units. The endowment policy recites that '[t]he objective of the contract for Variable Annuity Certificate will be the preservation and increase of the relative purchasing power of the initial dollar value of the annuity units.' In line with this objective, the dollar return from the annuity units would fluctuate with the value and the amount of return from the corpus of the fund from which the annuities are paid. We have said that an annuity is a yearly payment of a certain sum of money granted to another in fee, or for life, or for a term of years, charging the person of the grantor only. It is a stated sum, payable annually. Strakosch v. Connecticut Trust & Safe Deposit Co., 96 Conn. 471, 491, 114 A. 660; Bartlett v. Slater, 53 Conn. 102, 107, 22 A. 678; Commissioner v. Hale, 315 Mass. 556, 558, 53 N. E. 2d 675. Insurancewise, it has the same meaning. 1 Appleman, Insurance Law & Practice, § 81; 1 Couch, Insurance, p. 38. The policy to be issued under the annuity option would provide for the payment, not of a fixed amount of money, but of an uncertain sum, which is quite different from the legal

[1] 144 Conn. at p. 355, 131 A. 2d at p. 839.

concept of the word 'annuity.' Here again, the legislature employed a term generally used and understood, and it must be assumed that it did so intending that annuity payments should be in definite sums of money.'"[1]

4. The ruling of the Court of Appeals introduces a novel and legally unwarranted test under the Securities Act which is administratively impractical.[2] In place of the established legal principle that the legal character of a contract will be judicially determined from its substance the lower court would substitute irrelevant and immaterial criteria such as the type of corporate charter, the corporate name, the label affixed to the contract by the issuer, a layman's unilateral conclusion of law and possible remedy of an economic ill.

If the variable annuity contract is in Federal law to be held "insurance" because a state insurance commissioner says it is, what is it in a state, such as Connecticut, which says it is not? Is it "insurance" in the former; an "investment contract" or a scheme beyond control in the latter? What is it in a state such as West Virginia, the opinion of whose insurance commissioner was

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[1] The Connecticut insurance statutes do not define the term "annuity."

[2] The complaint alleges that VALIC is an "investment company" within the meaning of that term as defined in § 3(a) of the Investment Company Act of 1940. The resolution of this issue will flow from the judicial determination as to whether the variable annuity contract is an "investment contract" or is exempted because it is an "insurance . . . or annuity contract." Should this Court decide that the contract is exempted by § 3(a)(8) of the Securities Act there is no need to go further. On the other hand, if this Court concludes that the contract is not exempted, and since the issuance of this contract is respondents' principal business, then respondents cannot qualify under the exemption of "Insurance Company" in § 2(a)(17) of the Investment Company Act as their "primary and predominant business activity" would not be "the writing of insurance." Nor is it necessary for this Court to be concerned with the alleged defense of lack of jurisdiction in the SEC by virtue of the McCarran-Ferguson Act. If the contract is "insurance" or an "annuity" it is exempted by express provision of the Securities Act. If it does not so qualify then certainly it cannot be said that Federal jurisdiction has been waived under the limiting phrase "the business of insurance" which is the subject matter of the McCarran-Ferguson Act.

one of those relied upon by the lower court; should that State's Commissioner of Securities prevail in a pending action to enjoin its sale unless VALIC complies with the State's securities laws?[1] Must application and enforcement of the Federal securities law be held in abeyance pending determination by the insurance commissioner of each state as to whether the contract is insurance? We submit that Congress would not and did not leave to the varying whims and economic predilections of individual insurance commissioners, or even state legislatures, the right to determine whether any contract to which they choose to attach the label "insurance" or "annuity" shall be exempted from the provisions of the Securities Act. We do not believe that Congress would leave to implication, uncertainty and conflict such an important segment of the overall question of Federal jurisdiction which it was dealing with when it could easily have been provided for if such was its intention. The test as enunciated by the Court of Appeals is derogatory of the function of the Federal judiciary. It raises an important question of statutory construction of Federal law which should be settled by this Court to avoid a multiplicity of lawsuits and to make certain nationally uniform jurisdiction, administration, application and enforcement of the Federal securities laws. We submit that the Congress did not intend that entities chartered as insurance companies, with their great financial resources, should be permitted to issue, offer and sell securities through the mails and instrumentalities of interstate commerce without compliance with Federal securities law, simply by having a *single* state insurance commissioner, in his administrative capacity, declare that the contract is "insurance." Such a construction should

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[1] *State of West Virginia ex rel. Edgar B. Sims, its Commissioner of Securities v. Variable Annuity Life Insurance Company of America, Inc.*, pending in the Circuit Court of Kanawha County, West Virginia, Docket No. 24,449.

not be given to an Act of broadly remedial character designed to reach substance rather than form. Cf. the declaration of policy in § 1 of the Investment Company Act (15 U. S. C. § 80a-1).[1]

The decision below would afford a ready method of evading the Federal securities laws. But, this Court has said that: "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *SEC v. Howey*, 328 U. S. 293, 301 (1946). If the principle which the decision below establishes is permitted to stand, corporations chartered as insurance companies may claim exemption from Federal jurisdiction in any field of activity in which they choose to engage if a state insurance commissioner declares that the activity is "the business of insurance."

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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National Association of Securities Dealers, Inc.

August, 1958.

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[1] App. A, *infra*, p. 21.

APPENDIX A

Pertinent Provisions of Statutes

SECURITIES ACT OF 1933 AS AMENDED

AN ACT

To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

* * * * *

Sec. 2. When used in this title, unless the context otherwise requires—

(1) the term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

* * * * *

Sec. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

* * * * *

Sec. 3. (a)(8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

* * * * *

Sec. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

* * * * *

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

* * * * *

Sec. 20. (b) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States, United States court of any Territory, or the United States District Court for the District of Columbia to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. * * *

* * * * *

Sec. 22. (a) The district courts of the United States, the United States courts of any Territory, and the United States District Court for the District of Columbia shall have jurisdiction of offenses and violations under this title and under the rules and regulations promulgated by the Commission in respect thereto, and concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this title. Any such suit or action may be brought in the

district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 225 and 347) * * *

INVESTMENT COMPANY ACT OF 1940

AN ACT

To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Sec. 1. (a) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby found that investment companies are affected with a national public interest in that, among other things—

(1) the securities issued by such companies, which constitute a substantial part of all securities publicly offered, are distributed, purchased, paid for, exchanged, transferred, redeemed, and repurchased by use of the mails and means and instrumentalities of interstate commerce, and in the case of the numerous companies which issue redeemable securities this process of distribution and redemption is continuous;

(2) the principal activities of such companies—investing, reinvesting, and trading in securities—are conducted by use of the mails and means and instrumentalities of interstate commerce, including the facilities of national securities exchanges, and constitute a substantial part of all transactions effected in the securities markets of the Nation;

(3) such companies customarily invest and trade in securities issued by, and may dominate and control or otherwise affect the policies and management of, companies engaged in business in interstate commerce;

(4) such companies are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets; and

(5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors.

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment com-

panies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their busi-

ness, or when the control or management thereof is transferred, without the consent of their security holders;

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves.

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

* * * * *

Sec. 2. (a)(17) "Insurance Company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

* * * * *

(21) "Issuer" means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.

* * * * *

Sec. 3. (a) When used in this title, "investment company" means any issuer which—

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

As used in this section, "investment securities" includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies.

* * * * *

Sec. 3. (c) Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:

(3) Any bank or insurance company * * *

* * * * *

Sec. 7. (a) No investment company organized or otherwise created under the laws of the United States or of a State and having a board of directors, unless registered under section 8, shall directly or indirectly—

(1) offer for sale, sell, or deliver after sale, by the use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person; or offer for sale, sell, or deliver after sale any such security or interest, having reason to believe that such security or interest will be made the subject of a public offering by use of the mails or any means or instrumentality of interstate commerce;

(2) purchase, redeem, retire, or otherwise acquire or attempt to acquire, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person;

(3) control any investment company which does any of the acts enumerated in paragraphs (1) and (2);

(4) engage in any business in interstate commerce; or

(5) control any company which is engaged in any business in interstate commerce.

The provisions of this subsection (a) shall not apply to transactions of an investment company which are merely incidental to its dissolution.

* * * * *

Sec. 8. (a) Any investment company organized or otherwise created under the laws of the United States or of a State may register for the purposes of this title by filing with the Commission a notification of registration, in such

form as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. An investment company shall be deemed to be registered upon receipt by the Commission of such notification of registration.

* * * * *

Sec. 24. (a) In registering under the Securities Act of 1933 any security of which it is the issuer, a registered investment company, in lieu of furnishing a registration statement containing the information and documents specified in schedule A of said Act, may file a registration statement containing the following information and documents:

(1) such copies of the registration statement filed by such company under this title, and of such reports filed by such company pursuant to section 30 or such copies of portions of such registration statement and reports, as the Commission shall designate by rules and regulations; and

(2) such additional information and documents (including a prospectus) as the Commission shall prescribe by rules and regulations as necessary or appropriate in the public interest or for the protection of investors.

(b) It shall be unlawful for any of the following companies, or for any underwriter for such a company, in connection with a public offering of any security of which such company is the issuer, to make use of the mails or any means or instrumentalities of interstate commerce, to transmit any advertisement, pamphlet, circular, form letter, or other sales literature addressed to or intended for distribution to prospective investors unless three copies of the full text thereof have been filed with the

Commission or are filed with the Commission within ten days thereafter:

(1) any registered open-end company;

(2) any registered unit investment trust; or

(3) any registered face-amount certificate company.

(c) In addition to the powers relative to prospectuses granted the Commission by section 10 of the Securities Act of 1933, the Commission is authorized to require, by rules and regulations or order, that the information contained in any prospectus relating to any periodic payment plan certificate or face-amount certificate registered under the Securities Act of 1933 on or after the effective date of this title be presented in such form and order of items, and such prospectus contain such summaries of any portion of such information, as are necessary or appropriate in the public interest or for the protection of investors.

(d) The exemption provided by paragraph (8) of section 3 (a) of the Securities Act of 1933 shall not apply to any security of which an investment company is the issuer. The exemption provided by paragraph (11) of said section 3 (a) shall not apply to any security of which a registered investment company is the issuer, except a security sold or disposed of by the issuer or bona fide offered to the public prior to the effective date of this title, and with respect to a security so sold, disposed of, or offered, shall not apply to any new offering thereof on or after the effective date of this title.

* * * * *

Sec. 42. (e) Whenever it shall appear to the Commission that any person has engaged or is about to engage in any act or practice constituting a violation of any provision of this title, or of any rule, regulation, or

order hereunder, it may in its discretion bring an action in the proper district court of the United States, or the proper United States court of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices and to enforce compliance with this title or any rule, regulation, or order hereunder. Upon a showing that such person has engaged or is about to engage in any such act or practice, a permanent or temporary injunction or decree or restraining order shall be granted without bond * * *

* * * * * *

Sec. 44. The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this title or the rules, regulations, or orders thereunder * * *

* * * * * *

McCARRAN-FERGUSON ACT.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled. That the Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

Sec. 2. (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the

several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

Sec. 3. (a) Until June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, and the Act of June 19, 1936, known as the Robinson-Patman Antidiscrimination Act, shall not apply to the business of insurance or to acts in the conduct thereof.

(b) Nothing contained in this Act shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.

Sec. 4. Nothing contained in this Act shall be construed to affect in any manner the application to the business of insurance of the Act of July 5, 1935, as amended, known as the National Labor Relations Act, or the Act of June 25, 1938, as amended, known as the Fair Labor Standards Act of 1938, or the Act of June 5, 1920, known as the Merchant Marine Act, 1920.

APPENDIX B

Opinion

UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 14,253

SECURITIES AND EXCHANGE COMMISSION, APPELLANT

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, INC., and
EQUITY ANNUITY LIFE INSURANCE COMPANY, APPELLEES

No. 14,254

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., APPELLANT

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, INC., and
EQUITY ANNUITY LIFE INSURANCE COMPANY, APPELLEES

Appeals from the United States District Court for the District of Columbia

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Decided May 22, 1958

Mr. Myer Feldman, Special Counsel, Securities and Exchange Commission, with whom *Messrs. Thomas G. Meeker,* General Counsel, Securities and Exhange Com-

mission, and *Pace Reich,* Attorney, Securities and Exchange Commission, were on the brief, for appellant in No. 14,253.

Mr. John H. Dorsey, with whom *Messrs. John W. Lindsey, Bolling R. Powell, Jr.,* and *Edward G. Howard* were on the brief, for appellant in No. 14,254.

Messrs, James M. Earnest and *Roy W. McDonald* of the bar of the Court of Appeals of New York, *pro hac vice,* by special leave of court, for appellee Variable Annuity Life Insurance Company of America, Inc.

Mr. Benjamin H. Dorsey, with whom *Messrs. Smith W. Brookhart* and *Ralph E. Becker* were on the brief, for appellee Equity Annuity Life Insurance Company.

Before WILBUR K. MILLER and DANAHER, *Circuit Judges,* and MADDEN, *Judge,* United States Court of Claims.*

MADDEN, *Judge:* Securities and Exchange Commission, (SEC), brought suit in the District Court seeking an injunction restraining Variable Annuity Life Insurance Company of America, Inc., (VALIC), from selling or offering for sale certain contracts or policies unless and until the contracts or policies were registered with SEC in accordance with section 5 of the Securities Act of 1933, 48 Stat. 74, 77, 15 U. S. C. § 77 (e), and unless VALIC complied with section 7 (a) of the Investment Company Act of 1940, 54 Stat. 789, 802, 15 U. S. C. § 80a-7 (a). On their own motions the National Association of Securities Dealers, (NASD), and the Equity Annuity Life Insurance Company, (EALIC), intervened on the sides of the plaintiff and the defendant, respectively.

The District Court dismissed the complaint, and the plaintiffs have appealed from that judgment. The orig-

* Sitting by designation pursuant to provisions of Sec. 291 (a), Title 28, U. S. Code.

inal defendant and the intervening defendant sell the same kinds of contracts or policies. Those of VALIC will be discussed in this opinion.

The appellees contend that the contracts which they sell and which are the subject of this controversey are annuity policies and are therefore covered by the law relating to insurance, and not by the law relating to securities. They point to section 3 (a) (8) of the Securities Act of 1933, 15 U. S. C. § 77 (c)(a)(8) which says:

> SEC. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:
>
> * * * * *
>
> (8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

They point to section 3 (c) (3) of the Investment Company Act of 1940, 15 U. S. C. §80a-3(c)(3) which says that an insurance company is not an investment company within the meaning of the Act, and to section 2 (a) (17) of that Act, 15 U. S. C. § 80a 2 (a) (17) which says:

> (a) When used in this title, unless the context otherwise requires—
>
> * * * * *
>
> (17) "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

They point to the McCarran-Ferguson Insurance Regulation Act of March 9, 1945, 59 Stat. 33; 15 U. S. C. §§ 1011-1015, which says:

> * * * That the Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.
>
> SEC. 2. (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.
>
> (b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided*, That after January 1, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.
>
> * * * * * *
>
> SEC. 5. As used in this Act, the term "State" includes the several States, Alaska, Hawaii, Puerto Rico, and the District of Columbia.

Although VALIC sells what are undoubtedly life insurance contracts, they are tied in with its "annuity" contracts, and are a small part of its total business. If its "annuity" contracts are not annuity contracts within the meaning of the word annuity in the Securities Act of 1933, and within the contemplated business of insurance, as

that word is used in the Investment Company Act and the McCarran-Ferguson Act, the "annuity" label which VALIC places upon its contracts will not avail it.

We lay aside the life insurance feature of the policies, and discuss the annuity feature. In fact, as we understand it, if the applicant for an annuity policy is insurable, for life insurance purposes, he must take at least a five year term life insurance policy. That seems to us to be irrelevant to the question of the nature of the predominant annuity feature of the policy. We will therefore discuss a naked deferred annuity policy such as would be issued by VALIC to one uninsurable for life insurance purposes.

The policy holder agrees to pay a fixed sum of money per year for each year until he reaches the age when his deferred annuity will begin to pay out. A considerable part of what he pays for the first year, and a smaller part of what he pays thereafter are taken by the company for selling and administrative expense and profit. The rest is invested, at the discretion of the company, in securities which, it is hoped, will produce an income or show a capital gain or both. The policy holder is given periodic statements showing what the company has bought with what he and the other policy holders have paid in. These are statements of his "accumulation units." If, for example, the common stocks which the company held at the time the policy holder paid his annual premium were cheap, he would acquire, for the dollars he paid in, a larger number of "accumulation units", since the price or value of the "accumulation units" would be determined by dividing the value of the company's holdings by the number of the units. If thereafter the value of the company's holdings increased, the policy holder would still have the

same number of units, but the value of each unit would be higher. If the value of the holdings decreased, the result would, of course, be the opposite.

Throughout the paying-in period, the value of the policy holders' accumulations would fluctuate with the price of the securities in which the company invested its funds. The policy holder would hope that the long run trend of the prices would be upward. If so, "accumulation units" which he acquired in the early years for $1.00 might be worth $1.50 or $2.00 by the time his deferred annuity came due.

When the time comes for the company to begin to pay the deferred annuity, the policy holder acquires no more "accumulation units" since he will pay no more premiums. The number of "accumulation units" which he has acquired during the years of his payment of premiums will be multiplied by the then value of an accumulation unit, and that dollar amount will be the amount upon which his annuity will be computed. Using the mortality table appropriate to his age and sex, and assuming that 3½ percent interest can be earned upon the funds of the company until they are paid out, the dollar amount, per month, of his annuity is determined, and he is paid that amount for one month. The payments thereafter are determined according to the success of the company with its investments, and may be smaller or larger than the first month's payment. If the value of the "accumulation units", the number of which was fixed when the premium payments stopped, increases, the annuity payments will increase at that time to what they would have been if the units had had that value at the time the first month's annuity had been computed.

The arrangement is, of course, novel. It has been invented in an attempt to obviate the lack of reality of the traditional life insurance and annuity policy in relation to the value of the dollar. Annuity policies bought to provide a living in his latter years for the policy-holder annuitant, and life insurance policies bought to provide for the families of deceased policy holders have proved inadequate because of the decline of the value of the dollar in terms of purchasing power. Persons who have paid for life insurance or annuities have wished that they had bought, instead, tangible things or equities which would have, or might have, kept pace with the inflation of prices. There was room and need for experimentation in an effort to meet this serious problem. The contracts or "policies" offered by VALIC are an experiment in that direction. The question in this litigation is whether these contracts are "insurance" contracts, within the meaning of the statutes quoted above.

The Superintendent of Insurance of the District of Columbia, after due inquiry, issued to VALIC a certificate of authority "to transact within the District of Columbia the business of Life Insurance and Variable Annuities." Insurance Commissioners of three other States have issued similar licenses. The opinion of these officials, charged with the task of careful supervision of the business of insurance to protect the public from imposition, that the business of VALIC is the business of insurance, is important.

Elements of similarity between the "variable annuity" here in question and the traditional annuity may be noted. Both provide that the policy holder may elect at what time between certain stated ages, such as 50 and 70, the annuity payments are to begin. Both provide that the

policy holder may cash in the value of his annuity before annuity payments begin. Both provide a loan value for the annuity contract. Both provide for the payment to beneficiaries in case of the death of the annuitant before annuity payments begin. Both provide that if the policy holder ceases paying premiums, a reduced annuity is nevertheless acquired for the payments he has made. Both provide options whereby payments may continue to another beneficiary after the death of the principal annuitant, and other options. Both have provisions making the annuity payments exempt from the claims of creditors.

It is apparent that the VALIC contract bears many resemblances to a conventional annuity policy. The appellants say that these resemblances are superficial; that the identifying quality of insurance is risk-shifting, and that in the VALIC contracts the policy holder bears his own risk, the risk that the company's investments of his premiums will increase or decrease in value. But perhaps the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last. If everyone died on the day set for him by the mortality tables, there would be no point in paying an insurance company for doling out one's funds. A savings account, or Government or municipal or good corporate bonds, or a simple trust would do as well. VALIC, by the fact of issuing an annuity policy, does assume the risk of when the annuitant will die. If it does not bear the risk itself, it provides the machinery whereby the risk is shifted from the individual to the group of policy holders.

The appellants urge that VALIC policy holders, like investors in investment companies, may lose their savings and ultimately fail to receive the protection which

they hoped to buy when they paid their premiums. That fact seems to us to be inherent in the nature of this experiment in annuity contracts. Holders of traditional annuity policies in Germany lost all their protection in the inflation of the twenties, and in France nearly all their protection in the post-war inflation. We have already adverted to the situation in this country. Experience in England has been similar.

The statutes which we have quoted above show an unmistakable determination on the part of Congress to leave the insurance business in the control of the States until Congress should in plain terms exert its power over some or all aspects of it. The appellants say that, by definition, the business of the appellees is not insurance. We find no such definition. The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance. The VALIC contracts have many qualities of the traditional business of insurance. They depart from the tradition only in their attempt to solve a problem badly in need of solution. Unless we confine insurance, by definition, to what has actually been done in the past under the name of insurance, and invent a new and distinctive name for this new business which so greatly resembles insurance, we should not contradict the insurance commissioners. The new business will need the expert and watchful supervision of these experts in insurance. We think the statutes lodge the responsibility with them.

The judgment of the District Court is

Affirmed.

Judgment

UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT.

No. 14,253 April Term, 1958.

SECURITIES AND EXCHANGE COMMISSION, APPELLANT,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, INC., and

EQUITY ANNUITY LIFE INSURANCE COMPANY, APPELLEES.

No. 14,254 April Term, 1958.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., APPELLANT,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, INC., and

EQUITY ANNUITY LIFE INSURANCE COMPANY, APPELLEES.

Appeals from the United States District Court for the District of Columbia

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Before: Wilbur K. Miller and Danaher, Circuit Judges, and Madden, Judge, United States Court of Claims.

These cases came on to be heard on the record from the United States District Court for the District of Columbia, and were argued by counsel.

ON CONSIDERATION WHEREOF, it is ordered and adjudged by this Court that the judgment of the said District Court appealed from in these cases be, and it is hereby, affirmed.

It is further ORDERED by the Court that appellees herein recover from appellant National Association of Securities Dealers, Inc., one-half the cost of printing their briefs in these cases, and have execution therefor.

Dated: May 22, 1958.

PER JUDGE MADDEN.

APPENDIX C

1956 Proceedings of the National Association of Insurance Commissioners (Semi-Annual Meeting); excerpt from Volume I:

[162] MEETING OF SUBCOMMITTEE ON VARIABLE ANNUITIES (K5)

The Subcommittee met in the Grand Ballroom of the Commodore Hotel on Monday, November 28, 1955, at 9:15 A. M.

The Chairman announced that this meeting was called for the purpose of giving all interested parties a further opportunity to express their views. The meeting was recessed at 10:15 A. M. with the object of affording Department personnel an opportunity to give further consideration to the problem.

163 SEMI-ANNUAL MEETING

The Committee held a closed meeting with members of the several Insurance Departments at 3:00 P. M. on November 29, 1955.

As a result of such meetings and in order to place the problem of the variable annuity in proper perspective, the Subcommittee directs your attention to the arguments advanced in behalf of and against the issuance of variable annuities by life insurance corporations.

The proponents contend that:

1. the fixed dollar annuity is not adequate to provide a realistic life income after retirement because it cannot reflect changes in the purchasing power of the dollar;

2. the inflationary aspects of the present economy, and the outlook for the continuance of the factors that make for inflation, indicate that this problem will not only remain but may become more aggravated;

3. some responsible organizations now meet this issue by participating in programs outside of the field of insurance without the advantage of the standards inherent in state regulation of insurance;

4. the sale of variable annuities is already in existence and to the extent that experience is available, the program is meeting the hope and promises of its advocates.

The opponents contend that:

1. the strong possibility of misunderstanding on the part of the public might discredit the life insurance industry particularly if a decline in the value of common stock should cause an appreciable lowering of income payment to annuitants, at a time when there is no corresponding increase in the purchasing power of the dollar;

2. the possibility of extending federal regulation to the life insurance industry since the contracts of variable annuities, aside from the mortality aspect, are in most respects identical to the investment contracts now under federal supervision;

3. the risk of placing in further jeopardy the present tax status of life insurance companies and annuities;

4. to the extent that mortality rates and expense factors are guaranteed by life insurance companies that sell both regular life insurance contracts and variable annuities, certain inequities may develop adversely affecting other policyholders.

While there are other arguments both in favor of and opposed to the idea of variable annuities, the Subcommittee felt that these were of the greatest import.

In this connection it may be observed that recognized leaders in the industry are found on either side of the question. So divided is this opinion, that the trade associations in the life insurance field thus far have been unable to come forward with any concrete recommendations toward the solution of this problem.

After careful study, the Subcommittee recommends, that this association take no action either approving or disapproving the sale of variable annuities by life insurance companies at this time.

However, if any state permits the sale of variable annuities, it is recommended that such approval be conditioned upon the enactment of special legislation that will embody safeguards to protect the public. Such provisions should be drawn after due consideration of the following:

1. whether variable annuities should be sold only by a separate and distinct company or whether their sale should be permitted by life insurance companies. In this connection, a majority of the Subcommittee believes it more desirable to limit the sale of such contracts to separate and distinct companies limited to such activity;

2. that a balance between fixed dollar income and variable annuities should be achieved and maintained;

3. regulation and establishment of standards for investments should be carefully spelled out to include, but not be limited to, the following:

(a) prohibit investment in the common stock of any insurance company, national, state bank, or trust company;

(b) limit investment in common stock or shares of any corporation, joint stock association, or business trust in an amount not in excess of three percent of its total issued and outstanding common stock or shares of such corporation, association or trust;

(c) prohibit investment in shares of common stock unless the earnings available for dividends of the issuing corporation meet prescribed standards and provided further that the corporation has maintained an earning or dividend record for a specified number of years;

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(d) outlaw investment in any common stocks or shares which at the time of investment are not registered on a national securities exchange as provided in an Act of Congress of the United States entitled "Securities Exchange Act" of 1934, approved June 6, 1934, as amended;

(e) prohibit conflicts of interest including any between officers and directors of the variable annuity company and the corporation whose stock is purchased;

4. supervision over the company including the issuance and sale of variable annuity contracts should come under the jurisdiction of the state insurance department;

5. standards should be prescribed for contract forms and applications therefor which cannot be used until the insurance department has approved them;

6. the corporation should report annually to all variable annuitants after the text and format of such report has been approved by the commissioner;

7. the corporation should be subject to statutes prohibiting discrimination, misrepresentation, estimate of prospective benefits, and the Unfair Trade Practice Act;

8. in order that purchase of variable annuities should not be used as a means of stock market speculation, payment of cash values in a lump sum should be prohibited and instead, payment disbursed over a reasonable period of not less than three to five years;

9. consideration should be given to limitation of expenses.

10. in case of stock insurance companies issuing variable annuity contracts, there should be a provision strictly limiting net earnings including realized and unrealized profits, allocable to stockholders;

11. companies should be subject to all of the procedural provisions of the insurance law with which life insurance companies must comply, including requirements as to examination, audit of reports, service of process, voucher requirement, liquidation, etc.;

12. prohibit the borrowing of money or hypothecation of assets.

With the rendition of the report, the Subcommittee requests that it *[be discharged.]* (continue to serve at the pleasure of the Life Insurance Committee.)

* Matter in [brackets] deleted and matter in (parentheses) added. See pages 152; 167.

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No. 237

IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.,

Petitioner,

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA,

and

EQUITY ANNUITY LIFE INSURANCE COMPANY,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., PETITIONER

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IN THE

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Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., PETITIONER

Opinions Below

The opinion of the Court of Appeals (R. 885-893)[1] is reported at 257 F. 2d 201. The opinion of the District Court (R. 82-94) is reported at 155 F. Supp. 521, and its Findings of Fact and Conclusions of Law are printed in the record (R. 94-112).

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[1] References to the printed joint appendix and the certified opinion and judgment of the Court of Appeals are indicated as (R.); to additional parts of the record printed pursuant to this Court's Rule 26 as (RS.); and to unprinted parts of the record as (Tr.). Italics are supplied unless otherwise indicated.

Jurisdiction

The judgment of the Court of Appeals was entered May 22, 1958 (R. 895). The National Association of Securities Dealers, Inc. (NASD), intervenor-plaintiff, filed its petition for a writ of certiorari on July 30, 1958. The Securities and Exchange Commission (SEC), plaintiff, filed its petition (No. 290) on August 20, 1958. The petitions were granted October 13, 1958 and the cases consolidated. The jurisdiction of this Court rests on 28 U. S. C. § 1254(1).

Questions Presented

Whether "variable annuity" contracts, which are within the definition of "security" contained in § 2(1) of the Securities Act of 1933, and the issuers of such contracts, which are within the definition of "investment company" contained in §§ 3(a)(1) and (3) of the Investment Company Act of 1940, must be registered under those Acts or whether they are exempt therefrom as "insurance" or "annuity" contracts or "insurance companies" (by virtue of §§ 3(a)(8) and 3(c)(3) of the respective Acts) merely because (a) such contracts have been approved by the Superintendent of Insurance for the District of Columbia and the insurance commissioners of three states (notwithstanding that they lack certain indispensable elements of insurance) and (b) such issuers are chartered as "insurance companies" by the District of Columbia (notwithstanding that their principal business is the sale of such "variable annuity" contracts).

Statutes Involved

Statutes involved are the Securities Act of 1933 (Act of May 27, 1933, 48 Stat. 74, as amended, 15 U. S. C. § 77a), the Investment Company Act of 1940 (Act of August 22, 1940, 54 Stat. 789, 15 U. S. C. § 80a-1) and the McCarran-

Ferguson Act (Act of March 9, 1945, 59 Stat. 33, as amended, 15 U. S. C. §§ 1011-1015). Pertinent provisions of these statutes are set forth in Appendix A, *infra*, pp. 57-66.

Statement

I

The Action

This action was instituted by the SEC to enjoin Variable Annuity Life Insurance Company of America (VALIC) from violating the registration provisions of the Securities Act[1] and the Investment Company Act[2] by offering for sale and selling "variable annuity" contracts. The District Court had jurisdiction of the action by virtue of § 22 (a) of the Securities Act of 1933 (15 U. S. C. § 77v(a)) and § 44 of the Investment Company Act of 1940 (15 U. S. C. § 80a-43).

On their own motions NASD, petitioner herein, and Equity Annuity Life Insurance Company (EALIC) intervened on the sides of the plaintiff and the defendant, respectively.

NASD is a duly organized national securities association registered with the SEC (5 S. E. C. 627 (1939)) exercising powers in the over-the-counter securities market conferred by § 15A of the Securities Exchange Act of 1934, as amended (15 U. S. C. § 78o-3).

In their answers (R. 11-25) VALIC and EALIC admit that they have sold and are selling and offering for sale "variable annuity" contracts through the mails and means

[1] Sections 5(a)(1) and 5(c) of the Securities Act of 1933, 15 U. S. C. §§ 77e(a)(1) and 77e(c).

[2] Section 7 of the Investment Company Act of 1940, 15 U. S. C. § 80a-7.

or instrumentalities of interstate commerce and that they have not complied with the provisions of the Securities Act of 1933 and the Investment Company Act of 1940. They deny that the "variable annuity" contract is a security and that they are investment companies. Affirmatively they plead that: (1) the "variable annuity" contract is "insurance" and an "annuity contract" exempt from registration by § 3(a)(8) of the Securities Act; (2) they are "insurance companies" exempt from registration by § 3(c)(3) of the Investment Company Act; and (3) the offering for sale and the selling of such contracts is "the business of insurance" exempt from Federal jurisdiction by the McCarran-Ferguson Act.

II

The Facts

The material facts are not in dispute and may be summarized as follows:

A

THE HISTORY OF VALIC AND EALIC

VALIC and EALIC are chartered as stock life insurance companies in the District of Columbia.[1] VALIC was first "authorized to transact within the District of Columbia the business of Life Insurance" on April 30, 1956 (Defs. Exh. No. 6, 817, 406).[2]

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[1] EALIC stipulated that its contracts were in all material respects the same as those issued by VALIC (R. 84). In view of this stipulation it is unnecessary to detail the activities of EALIC. When we speak of VALIC in this brief, we include EALIC as well.

[2] Its deposit at that time "for the benefit of all policyholders of the company" consisted "of securities of the par value of $105,000 * * * worth not less than $102,900" (R. 816). Subsequently, on February 27, 1957, the Superintendent certified that VALIC had increased the deposit to "securities, of the par value of $211,000" having a worth of "not less than $200,000" (R. 822).

VALIC was authorized, by administrative action of the respective insurance commissioners, to sell "variable annuity" contracts in West Virginia on August 24, 1956 (R. 823-824); in Kentucky on February 4, 1957 (R. 831-832); and in Arkansas on May 9, 1957 (R. 832-833). In those states in which VALIC has not been licensed "it will also receive and process applications received by mail direct from an applicant" (Pls. Exh. No. 22 (R. 777, 787, 378)).

The principal business of VALIC is the sale of "variable annuity" contracts, which first came into being in 1952 (R. 490).[1]

VALIC and EALIC are the first chartered life insurance companies selling and offering for sale "variable annuity" contracts in the guise of "insurance."

B

VALIC'S "VARIABLE ANNUITY" CONTRACT

VALIC offers for sale and sells to the public numerous types of contracts based on the same investment principle. "Plaintiff's Exhibit No. 1, entitled 'Deferred Variable Annuity Policy', was received in evidence as a specimen of all the contracts that employ such investment practice."[2] It was so considered by the Court of Appeals (R. 889).[3] This contract was analyzed by Mr. Russell Owen Hooker (R. 125-299), who was actuary of the Connecticut State Insur-

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[1] VALIC's expert witness Maclean, an actuary and author of insurance texts (R. 474-477), testified:

"* * * any definition of an annuity promulgated, written, prior to the year 1952, naturally did not contemplate or include within its terms the possibility of a variable annuity" (R. 490).

[2] District Court opinion (R. 84), 155 F. Supp. at p. 523. The exhibit is printed in the record (R. 567-576; admitted in evidence R. 125). VALIC's expert witness testified that all its contracts employed the same investment principle (R. 492-497).

[3] 257 F. 2d at p. 203.

ance Department from 1928 to 1956 and is otherwise well qualified in the field (R. 115-123). His testimony is not controverted.[1]

1. Provisions of the "Variable Annuity" Contract.

The purchaser of a "Deferred Variable Annuity Contract," whom we shall refer to as "the investor" (referred to in the contract as "the annuitant"),[2] agrees to make specified periodic payments to VALIC during a stipulated period from ages 0 to 70 years.[3] After deducting "loading charges" that are retained by VALIC for expenses and profits, the net remaining from each payment is invested by VALIC in a fund for the account of the investor.[4] This fund is exclusively managed, controlled and operated by VALIC. The contract contains no specification of the manner in which VALIC is to invest the capital thus made available to it nor the precise manner in which investment increments, if any, are to be distributed to investors.[5]

At the time of each payment the investor purchases and is credited with a number of shares in the fund (referred to

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[1] In his analysis of the contract Hooker used charts (Pls. Exhs. Nos. 3-A through 3-Q (R. 631-646, 184, 358-360)), all of which cite the provisions of the contract including reference to terms defined and employed therein which are peculiar to it and foreign to "insurance" nomenclature. Statements herein with reference to the provisions of the contract are supported by this testimony.

[2] Pls. Exh. No. 1 (R. 567).

[3] Pls. Exh. No. 1, "Premiums" (R. 567), and par. 5(d) (R. 570); Pls. Exh. No. 2, being VALIC's "General Information and Rates" book (R. 579 at pp. 615-627, 126).

[4] Pls. Exh. No. 1, par. 4 (R. 568). See also undisputed expert testimony detailing how this is accomplished by operation of the contract's provisions (R. 134-163).

[5] Hooker testified:

> "It should be noted that the contract is not specific as to the presumption of accrual basis for income, nor as to investment expense, nor as to how the denominator [value of assets invested or available for investment] of the [gross investment] rate is to be calculated. It [the contract] says, 'Determined each month from the total investment experience of the Company.'
>
> "It would seem that the Company has some latitude, according to the contract, according to my analysis of it, in determining just what should go in there" (R. 138).

in the contract as "accumulation units"),[1] determined by dividing the current value of a share at the time of payment into the net payment.[2] The value of the shares fluctuates with VALIC's investment experience. The contract provides that at least once each year VALIC shall notify each investor of the total number of shares ("accumulation units") credited to his account and the dollar value of each share as of the date of notification.[3]

Throughout the period during which the investor makes periodic payments (referred to herein as the "accumulation period") he may at any time cash in his shares at current value (this the contract calls "cash value") as a result of which he may realize a profit or loss.[4] During this same period the investor may cash in a portion of his shares at current value (this the contract calls a "policy loan").[5] If he reinvests (repays) what the contract terms a "policy loan" he is not necessarily credited with the same number of shares he cashed in. Instead, his "repayment" purchases shares at their current value as of the date of "repayment." Thus the investor may on "repayment" acquire a greater number of shares than he would have had if he had not entered into the "loan" transaction, or a lesser number.[6] This is in contrast to true insurance policies or annuity contracts which set forth and guarantee *fixed* "cash values" and "loan values."[7]

During this period the investor may also speculate by taking advantage of the so-called "Grace Period"[8] and by

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[1] Pls. Exh. No. 1, par. 4 (R. 568).
[2] Expert testimony (R. 134-163).
[3] Pls. Exh. No. 1, par. 4(c) (R. 568). A copy of such a notification is in evidence (Pls. Exh. No. 18 (R. 743, 367)).
[4] Pls. Exh. No. 1, par. 14 (R. 572) and expert testimony (R. 168-171).
[5] R. 163-166.
[6] Pls. Exh. No. 1, par. 15 (R. 572) and expert testimony (R. 163-166).
[7] R. 123-124, 452, 498, 544, 556.
[8] Pls. Exh. No. 1, par. 2 (R. 568).

making payments "on or before" the due date[1] provisions of the contract. VALIC establishes the dollar value of a share ("accumulation unit") as of the last day of each month.[2] If the investor is of the opinion that the dollar value of a share will decrease by the end of a given month he can withhold his payment until the next month. If he guesses right he will receive more shares for the same payment. If he thinks the dollar value of a share will increase in the future he can make advance payments and purchase shares at current value.[3]

VALIC's expert witness, Maclean, testified that VALIC's operations during the accumulation period are similar to those of an investment company.[4]

Throughout the period during which the investor is making payments to VALIC there is no life or other insurable contingency involved.[5] The investors provide the capital, share in the earnings and profits, and bear the risk of loss resulting from investment of their funds by VALIC.[6]

By contrast, investment and mortality prognostications are used by an insurer to fix its selling price. The risk that premium rates so fixed may prove to be inadequate is borne by the insurer; and, should that result come about, it does not affect the contractual obligation of the insurer to the insured upon the occurrence of the insurable contingency.[7]

The "variable annuity" contract does not obligate the investor to participate in the investment fund to any fur-

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[1] Pls. Exh. No. 1, "Premiums" (R. 567).
[2] Pls. Exh. No. 1, par. 19 (R. 573).
[3] Findings of Fact, No. 48 (R. 108); expert testimony (R. 150-151).
[4] R. 492-493.
[5] R. 189-190, 245, 494.
[6] R. 163, 545; Findings of Fact, Nos. 49, 94 (R. 108, 111).
[7] R. 163, 438, 461.

ther extent than that set forth above. It does give the investor an *election* to take cash or to purchase a so-called "variable annuity" between the ages of 50 and 70 years.[1] If he *elects* the "variable annuity," he makes a "capital payment" (R. 254) to VALIC computed by multiplying the number of shares ("accumulation units") credited to his account times the current value of a share. For each $1000 of this payment VALIC pays him a *first* monthly payment of less than $10 per thousand, computed on the basis of the Progressive Annuity Mortality Table at 3½% interest (R. 175-178).[2] In a true annuity contract computed on the same basis the *same* monthly amount, guaranteed at the inception of the contract, would be paid to the annuitant for the entire term (R. 177-178, 452).

After the *first* monthly payment the investor is assured no specific, *or even any,* subsequent monthly payments during the term of the contract. Instead, he is credited with a number of shares (called "annuity units") in the investment fund (R. 178-182).[3] The future value of these shares ("annuity units") is speculative in that *all* monthly payments, *if any,* subsequent to the first, are computed by

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[1] Pls. Exh. No. 1, par. 5(d) (R. 570); expert testimony (R. 494). Pls. Exh. No. 2 (R. 603).

[2] From the inception of the contract up to the date of election the investor cannot know what capital he will have acquired, for he cannot foresee how many shares ("accumulation units") he will have purchased or their value as of the date of election (R. 160-161). Since, as admitted by VALIC's actuary and a member of its Board of Directors (R. 521-526), VALIC does "not guarantee the investment experience" (R. 545), it stands legally indifferent whether the value of the shares held by the investor at the date of election is more or less than the total amount invested. The investor has only the hope that VALIC's management, operation and control of the investment fund in which he has an aliquot share will result in a profit and not a loss.

[3] Numbers of "annuity units" credited to the purchaser's account is determined by dividing the first month's guaranteed payment by the current value of such unit. The number of units remains constant for the balance of the term of the contract (R. 175-182). One who elects to purchase a "variable annuity" contract when the value of an "annuity unit" is low will have more such units credited to his account than another making the same capital investment under the same contract when the value of the unit is high. The former, owning more shares, will receive larger payments than the latter in the same month (provided each unit has some value) although each has invested an identical amount of dollars.

the formula number of shares times the current monthly value of a share resulting from VALIC's operation, management and control of the investment fund (R. 496-497). Before the investor's interest can be known, VALIC deducts, as a prior charge, a management fee (1.8% per annum),[1] and investment taxes (undescribed in the contract and of uncertain amount).[2] The investor is paid each month for life, or other optional term, the uncertain future current monthly value, *if any*, of a share ("annuity unit") times the number of shares credited to his account. VALIC is legally indifferent what the value of a share, each month, may prove to be. The contract does not *assure* the investor that he will have a fixed dependable income, or any income, for the remainder of his life. Instead, he has only the hope of gain and bears the risks of loss resulting from VALIC's exclusive management, control and operation of the investment fund.

2. Insurance Benefits, If Included in the "Variable Annuity" Contract, Are *De Minimis*, Separate and Severable

VALIC requires that the purchaser of a deferred "variable annuity" contract, *if insurable* and within certain age limits, purchase a contract for 5-year decreasing term life insurance. Its "General Information and Rates" book states:[3]

> "All individual deferred annuity policies will be issued with a minimum amount of life insurance on the annual decreasing term plan unless the applicant fails to meet the Company's insurability requirements. In the case of *annual* premium policies, the initial amount of insurance in the first policy year will be equal to five times the annual basic annuity premium. In the case of *single* premium policies, the amount of

[1] R. 138-139, 546-551.
[2] R. 136-137; Pls. Exh. No. 1, pars. 18-22 (R. 573).
[3] Pls. Exh. No. 2 (R. 579 at p. 583).

life insurance in the first policy year will be equal to one-half of the single premium. In both the annual and single premium cases, the amount of insurance will decrease one fifth each year until at the end of the fifth year it will be zero.

* * *

"* * * Individual policies without life insurance will be issued to: (1) applicants from age 61 to 70, inclusive; and (2) from age 0 to 60 on uninsurable applicants."[1]

An investor may also *elect* to have included in his contract as a rider "A total and permanent disability premium waiver benefit."[2]

It is conceded that the 5-year decreasing term life insurance and the total and permanent disability premium waiver benefit are true insurance. But VALIC sells the bare "variable annuity" without such insurance.[3]

In those cases where the investor satisfies medical requirements and purchases one or both of the aforementioned types of insurance, the premium for the coverage is deducted from the amount he would otherwise have available for purchases of shares ("accumulation units") after VALIC has deducted its loading charges. Compared to the total payments made by the investor this amount is *de minimis*. In the case of the specimen contract,[4] which provides for the investor's payment of $1000 per year to VALIC, the cost of the 5-year decreasing term life insurance over the 5-year period would be $100.85, equal to a little over 2% of the total payments of $5000; and if the contract remained in force for 30 years of payments by the investor, out of total payments amounting to

[1] Pls. Exh. No. 2 (R. 579 at p. 586).
[2] Pls. Exh. No. 2 (R. 579 at p. 584).
[3] Testimony of VALIC's president (R. 517). In its reply brief filed in the District Court VALIC said (p. 24): "If VALIC sold no contract except deferred life annuity policies—if it offered no term insurance or premium waiver—it would be engaged solely in the life insurance business * * *."
[4] Pls. Exh. No. 1 (R. 567).

$30,000 only $100.85 or 3/10 of 1% would be applied to life insurance premiums.[1] The disability premium is $39.60 per annum.[2]

Of the decreasing term life insurance in force on December 31, 1956, 91.4% was reinsured by VALIC in another company; and of the disability insurance in force on the same date, 89.5%.[3]

VALIC's book "General Information and Rates" indicates that it offers, at the option of the purchaser of a "variable annuity," additional term insurance (Pls. Exh. No. 2 (R. 579 at pp. 583-584)). There is no evidence that VALIC has ever sold such insurance.

The District Court found that "The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund to be invested mainly in common stocks."[4] The Court of Appeals found that the life insurance contracts sold by VALIC "are a small part of its total business" and are "irrelevant to the question of the nature of the predominant annuity feature of the policy."[5]

3. The Format of and Terms Used in VALIC's "Variable Annuity" Contract

VALIC's "variable annuity" contracts are printed in a format usually associated with insurance contracts.[6] Found in them are insurance terms such as "cash value" and "loan value," but by definition therein they differ from and are at variance with the usual insurance meaning of the terms. Also found in the contracts are insur-

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[1] R. 126-132, 161-162.
[2] R. 132, 162.
[3] R. 186-188.
[4] Findings of Fact No. 94 (R. 111).
[5] 257 F. 2d 201, 203 (R. 888-889).
[6] Pls. Exhs. Nos. 1 (R. 567), 7 (R. 677), 8 (R. 681), 9 (R. 685), 10 (R. 689), 11 (R. 701) and 12 (R. 713).

ance terms such as "The Death Benefit," "The Beneficiary," "Grace Period," "Protection from Creditors," "Incontestability," "Suicide." Most of these can apply only to the 5-year decreasing term life insurance (*if* included in the contract) and are not relevant to the "variable annuity" provisions of the contracts.[1]

The terms in the contract which are the vitals of its so-called "variable annuity" are "gross investment rate," "net investment rate," "net investment factor," "accumulation unit," "value of an accumulation unit," "annuity unit," and "annuity unit value." These terms are not found in insurance nomenclature. VALIC's own actuary, a member of its Board of Directors, who said he had been retained by some 150 insurance companies, testified that other than in the VALIC and EALIC contracts he had never seen such terms in an insurance contract.[2]

C

VALIC'S SALES LITERATURE COMPARED WITH ITS "VARIABLE ANNUITY" CONTRACT

We respectfully suggest that the Court read VALIC's sales literature.[3] Only by observation of the typographical composition of the literature is its full import revealed. This Statement of Facts cannot reflect the emphasis attained by type and spacing employed; or qualification of apparent guarantees by the use of fine print.

This sales literature shows that VALIC seeks to impress upon prospective purchasers of its so-called "variable annuity" contracts that it is selling:

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[1] "Cash value," "loan value" and life insurance benefits, *if any*, apply only to the period during which the investor is making payments to VALIC. They have no application to the "variable annuity" period (R. 175).

[2] R. 554-555.

[3] Pls. Exhs. Nos. 19 (R. 745-758, 378), 20 (R. 761-767, 378), 21 (R. 769-776, 378), 22 (R. 777-789, 378), 23 (R. 793-794, 378) and 24 (R. 795-804, 378).

(a) "RETIREMENT WITH PROTECTED PURCHASING POWER" (R. 745);
(b) "INFLATION-PROOF ANNUITIES" (R. 761);
(c) Insurance against loss resulting from increase in the cost-of-living;
(d) An interest in a common-stock fund.

The following are a few excerpts that are typical of the tenor of the VALIC sales literature:

1. *Pls. Exh. No. 19* (R. 745):

"* * * a search was made for an anchor *to assure* purchasing power against fluctuations in the dollar value" (R. 749).

"* * * a way to provide *inflation-proof* retirement was found" (R. 749).

In stating the difference between a "variable annuity" and a conventional annuity:

"This difference is created by the investment by VALIC of a substantial amount *of your money* in business equities rather than in debt securities" (R. 750).

"The VALIC Plan, as we have said, is the means by which you can *assure* a comfortable inflation-proof old age * * *" (R. 754).

2. *Pls. Exh. No. 20*, blazoned with the caption "INFLATION-PROOF ANNUITIES" (R. 761), states that the "annuity payments * * * *will increase* in amount during an inflationary period" (R. 767).

3. *Pls. Exh. No. 21* unequivocally states that the purchaser's money is invested in common stocks (R. 772, 774). It also states that the contract holder's "proportionate ownership" in the fund is reflected by the shares which he purchases, the shares being called "units" (R. 774).

4. *Pls. Exh. No. 22* under the caption, "WHAT ARE THE ADVANTAGES OF THE VALIC PLAN?" (R. 781):

"The principal advantages of the VALIC Plan are as follows:

It provides an annuity income that cannot be outlived.

It *will reflect* the traditionally higher yields of equity investments.

It *will provide* an income which will tend to keep pace with the cost of living.

The VALIC PLAN *guarantees* that the policy holder will receive payments as long as he lives * * * [O]nly variable life annuities * * * can provide a life annuity based on * * * equity investments" (R. 781).

5. *Pls. Exh. No. 23:*

"Find out about variable annuities—*that provide retirement with protected purchasing power*" (R. 793).

EALIC, which stipulated that its "variable annuity" contracts were in all material respects the same as VALIC's, in a brochure "EQUITY ANNUITY—a new road to SECURITY," described the scheme (Pls. Ex. No. 17, RS. 899, Tr. 562)[1]:

"Our variable annuity program is designed to minimize the speculative features of common stock investments. You avoid the gamble of buying a single stock * * * [T]he company 'spreads the risk' by buying stocks in *many* of the nation's leading corporations * * * You avoid the risk of buying stocks at one point in the stock market * * * You avoid buying stocks on a 'hot tip'. Instead you benefit from the counsel of expert financial advisers * * * in short you get the benefit of expert diversification."

Pls. Exh. No. 19 (R. 745, 752-753) is an example of VALIC's sales techniques. Using two stock price indices entirely unrelated to VALIC activity ("Standard and Poor's Weekly Composite Index of 480 stocks for price and Standard and Poor's Daily Composite Index of 90

[1] RS. 899 refers to the record as reprinted under the supervision of the Clerk of this Court. It is p. 910 of the certified record.

stocks for yield''), VALIC presumes to show the prospective purchaser how he would have benefited had he invested in a "variable annuity'' instead of a conventional annuity during the period 1940-1955. The tables and graph set forth in the exhibit are based, not upon the experience of VALIC, but upon stock market averages of securities differing substantially from VALIC's portfolio.[1] VALIC obviously uses this technique to imply future results.

A comparison of the sales literature's statements and implications as to what the "variable annuity'' contract provides and the actual provisions of the contract[2] reveals that the contract does not insure "Retirement with Protected Purchasing Power,'' or against losses resulting from inflation or increase in costs of living, or "an annuity income that cannot be outlived.'' It does not even mention these objectives.[3] The only guarantee in the contract is a *first* monthly payment of less than $10 for each $1000 of capital payment (the amount of which is unforeseeable until the month of election). Every provision for subsequent monthly payments by VALIC is conditioned on its investment experience.

The contract does state that "The Company guarantees that the dollar amount of such installments after the first [monthly payment] shall not be affected by variations in the actual mortality experience of payees from the mortality experience assumptions of the Progressive Annuity Mortality Table.'' This is meaningless. The contract itself explicitly obligates VALIC to pay to each investor, for the term of his contract, an amount equal to the product of the current value of each "annuity unit''

[1] Defs. Exh. No. 38 (R. 849-850, 513).
[2] Pls. Exh. No. 1 (R. 567-576).
[3] While "inflation," with its attendant increase in the cost of living and depreciation in the value of the dollar, may be an insurable contingency, the "variable annuity" contract does not indemnify or guarantee against loss therefrom.

times the number of such shares credited to his account. It follows that the quoted reference to mortality is a mere redundancy because experienced departures from the expected mortality, whether in the direction of longer or shorter life, could have no effect on the operation of the basic formula which describes VALIC's obligation to pay under its contract.[1]

D

OPINIONS OF THE LOWER COURTS

1. The District Court

The District Court found that:

> "74. A VALIC and an EALIC contract holder invests money with the respective defendants with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased by VALIC and EALIC with the money invested by the contract holder, and his expectation of profit based upon the efforts of others applies to both the 'accumulation period' and to the repayment or variable annuity period" (R. 109-110).
>
> "49. The risk of profit or loss on investment is borne by the contract holders" (R. 108).
>
> "94. The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund to be invested mainly in common stocks" (R. 111).
>
> "93. The insurance features of such contracts do not alter the investment characteristics" (R. 111).

In its opinion the District Court stated that "[t]he logic of the law applied to the established facts seems to bring the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants within the terms and plans of the Investment Company Act" (R. 89).

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[1] Pls. Exh. No. 1, pars. 20-22 (R. 573).

It so found as a conclusion of law (R. 112). Without making a finding that the "variable annuity" contract is "insurance" and its sale "the business of insurance," the District Court denied the injunction because: (1) VALIC was chartered as an insurance company; and (2) its "variable annuity" contracts had been approved by the Insurance Superintendent of the District of Columbia and by the insurance departments of three states (West Virginia, Kentucky and Arkansas). From this premise the court reasoned that the provisions of the McCarran-Ferguson Act exempted the contract and its sale from compliance with the Federal securities laws (R. 90-91, 112).

2. The Court of Appeals

On appeal none of the parties excepted to the trial court's Findings of Fact.

The Court of Appeals said that:

> "* * * the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last."[1]

It then went on to show that the risk is *not shifted* by the "variable annuity" contract by saying:

> "The appellants urge that VALIC policy holders, like investors in investment companies, may lose their savings and ultimately fail to receive the protection which they hope to buy when they paid their premiums. That fact seems to us to be inherent in the nature of this experiment in annuity contracts."[2]

In affirming the District Court, in an opinion unsupported by reference to case law or other authorities, the Court of Appeals failed to find or hold that the "variable annuity" contract is "insurance" or an "annuity." It found that the sale of "variable annuity" contracts is a "novel" ar-

[1] 257 F. 2d at pp. 204-205 (R. 892).

[2] 257 F. 2d at p. 205 (R. 892). *Cf.* VALIC's sales literature, which emphasizes the hope of speculative gain. *Supra*, pp. 13-16.

rangement, a "new business" which "resembles insurance."[1] Paying no heed to the substance of the contracts, the court attached controlling weight to approval of the contracts by the Superintendent of Insurance for the District of Columbia and the insurance commissioners of three states.[2] It did not indicate that it had given consideration to the expert opinion of the SEC that the contracts are securities. Instead of adjudicating the legal issue presented as to whether the contracts are in substance a "security" or "insurance" the court supported its conclusion on its assertion that there is an economic need for such contracts, and that "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance."[3]

Summary of Argument

I. "Variable annuities" are "investment contracts" which are defined as "securities" by the Securities Act of 1933. Members of the public who purchase these contracts participate in a typical investment scheme: they hope to gain through investment of their funds by respondents, but they alone bear the risk of loss. Respondents do not assume any part of that risk. They only invest the buyers' contributions in common stocks, hoping to increase the value thereof for account of the buyers. This is true during the "annuity period" as well as the "accumulation period." This arrangement exactly meets the test of an "investment contract" laid down by this Court in *SEC v. W. J. Howey Co.*, 328 U. S. 293, 301 (1946): "The test is whether the scheme involves an investment of money in

[1] 257 F. 2d at pp. 204-205 (R. 890, 893).
[2] 257 F. 2d at pp. 204-205 (R. 891, 893).
[3] 257 F. 2d at p. 205 (R. 892).

a common enterprise with profits to come entirely from the efforts of others." Being securities, "variable annuity" contracts are subject to the registration requirements of the Securities Act.

II. Respondents are "investment companies" subject to the registration requirements of the Investment Company Act of 1940 because they are primarily engaged in investing, reinvesting, holding and trading in securities consisting mainly of common stocks which in value exceed 40% of respondents' assets.

III. The Securities Act of 1933 and the Investment Company Act of 1940, therefore, extend to respondents and the contracts they sell unless they are specially exempt from compliance. Respondents claim such exemption on the ground that they are "insurance companies" under the Investment Company Act, that "variable annuities" are "insurance" and "annuity contracts" under the Securities Act and that the business of selling them is "the business of insurance" under the McCarran-Ferguson Act. These arguments are without merit because, *inter alia:*

A. The word "insurance" in the exemptive portions of these statutes is used in its commonly accepted sense. In this sense "risk-shifting"—the shifting from the insured to the insurer of a risk of loss occasioned by the happening of an insurable contingency—is an indispensable element of the "insurance" concept. *Helvering v. Le Gierse,* 312 U. S. 531 (1941). "Variable annuities," however, embody no risk-shifting whatever. The risk of excessive longevity—which is insured against by an ordinary annuity—is not shifted to the issuers of "variable annuities," but remains on the shoulders of the contract holders because the issuers make no guarantee of *any* return

to them. Reference to or employment of insurance terminology, forms and tables in the contracts cannot make them "insurance" contracts in the absence of risk-shifting.

B. Approval of "variable annuity" contracts by four local insurance commissioners is without significance. There is no indication that Congress intended to authorize local insurance officials to determine the applicability of the Federal securities laws. Any such power would result in lack of uniformity and would defeat the congressional purpose in enacting those laws.

IV. "Variable annuities" are not "annuities." The essence of an "annuity" is periodic payment of a *fixed* sum. Payments under "variable annuity" contracts are by definition *not* fixed; instead they rise or fall depending on earnings or profits. *Booth v. Ammerman*, 4 Bradford Surr. 129 (N. Y. 1856); *Spellacy v. American Life Ins. Ass'n*, 144 Conn. 346, 131 A. 2d 834 (1957).

V. The exemption of the McCarran-Ferguson Act is expressly limited to "the business of insurance." The term "the business of insurance," as used in that Act, is used in its "commonly accepted sense." If "variable annuity" contracts are neither "insurance" nor "annuities," respondents' business of selling them is not "the business of insurance."

VI. The courts below misapplied the exemptive provisions of the controlling statutes because they failed to recognize that "variable annuities" lack the indispensable risk-shifting element of "insurance." The statutory exemptions do not apply to any contract that lacks this element.

VII. The Court of Appeals indicated that the possible economic value of "variable annuities" was a reason for affirmance. Such value is irrelevant. "Variable annuities," whether economically sound or not, can be sold under Federal securities regulation.

ARGUMENT

I

Respondents are Primarily Engaged in the Business of Selling to the Public Investment Contracts Defined by Law as Securities That Must be Registered Under the Securities Act of 1933

Respondents are in the business of selling investment contracts; those contracts are "securities" as defined by § 2(1) of the Securities Act of 1933; and those securities must therefore be registered under §§ 5 and 10 of the Act.[1]

Respondents' claim of exemption from the registration provisions of the Act by virtue of § 3(a)(8) thereof is discussed in subsequent portions of this brief.

A

Respondents Are Primarily Engaged in Selling Investment Contracts Known as "Variable Annuities"

The primary business conducted by respondents is selling "variable annuities" to the public. These contracts have been described above at length.

The contract disclosed by the evidence has every usual characteristic associated with an investment contract under

[1] The Securities Act of 1933, 48 Stat. 74, appears in the Code as 15 U. S. C. §§ 77a-77aa. The sections referred to above are designated in the Code as follows: § 2(1), § 77b(1); § 5(a), § 77e(a); § 10, 77j (Appendix A, *infra*).

the Securities Act of 1933 as well as in common understanding. If this device is not an investment contract, then the concept is hardly susceptible of practical application to anything that does not already bear the label. The Uniform Securities Act, already adopted in some states, treats "variable annuities" as securities and does not exempt them from blue sky regulation as insurance. See Loss & Cowett, Blue Sky Law (1958) 350, 356-357.

One fundamental distinction between a contract of investment and a contract of insurance lies in the incidence of risk. In an investment contract the investor takes the risk that at some time in the future the value of his investment will decline or disappear. In insurance and conventional annuities, however, this risk is shifted to the company, which guarantees the insured payment of a specific sum on the happening of an event or events—such as survival from month to month after attainment of retirement age—without reference to the losses it may suffer upon investment of the premiums paid in.

The risk of loss that is inseparable from investment is accompanied, of course, by the chance of gain. An investment such as a common stock may appreciate in absolute value over the holding period. Insurance does not provide this chance. When an insured or an annuitant shifts his risk of loss to the insurance company, he also gives up this chance of gain.

What of a "variable annuitant"? As the District Court found, he makes payments to one of the respondents "with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased" by the company with his money and that of other "variable annuitants." This hope or expectation

of profit exists throughout both the accumulation period and the "variable annuity" period. The "variable annuitant" always bears the risk of loss. The respondents do not take any part of that risk: like managers of investment companies, they are without legal responsibility to the "variable annuitants" for any investment, reasonably prudent when made, that happens suddenly to go bad. They cannot be held accountable for any losses to "variable annuitants" that stem from sudden drops in equity values caused by war, deflation, executive heart attacks, or any of a thousand other unforeseeable events that affect security values.

Finally, the hope of gain that is entertained by people who buy respondents' "variable annuities" rests solely on the hope that the gain will arise from respondents' skillful management of the security portfolio bought with the "variable annuitants'" money. The investors have no voice in the companies' investment policy. That is the sphere of the promoters. The people who put up the money must rely on the efforts and ability of respondents to produce their profits or limit their losses.

Exactly these considerations have been relied on by the courts in holding other and similar devices to be "investment contracts" within the meaning of § 2(1) of the Securities Act. The leading case is *SEC v. W. J. Howey Co.*, 328 U. S. 293 (1946). There a group of promoters offered to the public interests in land planted to citrus trees. Together with these interests they offered service contracts whereby the promoters undertook, for a fee, to cultivate each "landowner's" trees and harvest and market his crop, remitting the net profits to him. The "landowners" there, like the "variable annuitants" here, were people looking for a common enterprise managed by experts in

which they could put their money and from which they might realize profits. The Court held that they had bought "investment contracts" as that term is used in § 2(1) of the Securities Act of 1933, saying:

> "Thus all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed" (328 U. S. at p. 300).

Speaking more broadly, the Court laid down a rule applicable to all such situations:

> "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others * * * The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae" (328 U. S. at p. 301).

The trappings of "land ownership" surrounding the *Howey* scheme did not blind this Court to its substance as an investment contract and registerable security. The trappings of "insurance" and "annuities" that adorn the scheme contrived by respondents should likewise fail to mislead this Court. To the extent that "variable annuities" masquerade as "insurance" or "annuities," therefore, they are a sham. They should be treated as other investments are.[1]

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[1] In the lower courts VALIC has consistently cited *Haberman v. Equitable Life Insurance Soc'y.*, 224 F. 2d 401, reh. denied, 225 F. 2d 837 (5th Cir. 1955), *cert. denied*, 350 U. S. 948 (1956), in support of its argument that the "variable annuity" is not a security. That case was concerned only with whether a *true* annuity is a security under Texas law and it was held not to be. The case is inapposite to the issue in the instant case since § 3(a)(8) of the Securities Act of 1933 exempts *true* annuities from the provisions of that Act. As shown *infra*, the "variable annuity" is not an "annuity."

B

The "Variable Annuity" Investment Contracts Sold by Respondents Are Securities That Must Be Registered Under the Securities Act of 1933

Section 2(1) of the Securities Act defines a "security" as, *inter alia*, "any * * * certificate of interest or participation in any profit-sharing agreement [or] investment contract * * *." Any "security" so defined must be registered under §§ 5 and 10 of the Act before it can be offered for sale or sold to the public.

In the *Howey* case this Court held that the citrus grove device described above was a "security" within the terms of § 2(1) because it was an "investment contract" and therefore had to be registered, like other securities, for the protection of the public. Additional authority is hardly necessary; but there are a number of decisions to the same effect. See, *e. g.*, cases cited in Loss, SECURITIES REGULATION (1951) 318, where the author comments on the *Howey* case:

> "A great many other schemes—many of them of the Alice in Wonderland variety—have been brought under both federal and state umbrellas by this same process of looking through form to substance."

Twenty-five years ago Congress determined that the welfare of the public demands full and fair disclosure of all material facts concerning securities to be offered through the mails or in interstate commerce. It forbade material misrepresentations, even innocent ones, about such securities. Securities are purchased with the expectation of gain through another's efforts and skill, but ownership is always accompanied by the risk of loss. The business of selling them is one that too easily lends itself to misrepresentations. Unless this business is policed, the possibility

of profit tends to be emphasized and the risk of loss minimized by the natural cupidity of buyers and the equally natural desire of sellers to make sales (to say nothing of naive buyers and venal sellers).[1] Congress elected to base this policing on the requirement of registration under the Securities Act. Without full and fair disclosure there can be no registration, and without registration there can be no public offering or sale. This "disclosure regulation" under the Securities Act has worked so well and "with such salutary and beneficial results" that it "has been one of the significant developments of our time." *United States v. Morgan*, 118 F. Supp. 621, 646 (S. D. N. Y. 1953).

C

"Variable Annuities" Are Not Exempt From Registration as Being "Like" Insurance or Annuity Contracts Under § 3(a)(8) of the Act

Section 3(a)(8) exempts from the registration requirement of the Securities Act insurance or endowment policies or annuity contracts.

The House Report on the bill that became the Securities Act comments briefly on this exemption by noting that it

> "* * * makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes." H. R. Rep. 85, 73d Cong., 1st Sess. (1933) p. 15.

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[1] "* * * it is rather unrealistic to expect that the dealers, people who have something to sell, are not going to puff their merchandise when they sell * * * [T]he concept of a reluctant salesman is just about as visionary as that of a nation without a thirst." Hearings before the House Committee on Interstate and Foreign Commerce on H. R. 7550 and S. 2846 (to amend the Securities Act), 83d Cong., 2d Sess., p. 104 (1954) (testimony of Louis Loss).

In subsequent portions of this brief we will show that "variable annuities" are not insurance or annuities. Can a "variable annuity" contract be considered "like" an ordinary insurance or annuity contract? Certainly it was not so considered in 1933, for it did not then exist: it is a "novel" investment scheme concocted in 1952, seeking to assimilate by a qualifying adjective ("variable") an honorable name ("annuity") to which it is not entitled. But even if it had existed when the statute was passed, there could hardly have been any serious claim that it should be exempt from registration because it was "like" contracts providing insurance and annuities. The "variable annuity," as we have shown, is a vehicle for speculation in which all the risks of property ownership fall on the buyer, though all the "management" incidents of ownership (including management fees) are reserved to the promoters. Insurance and annuity contracts contain no element of speculation; they *guarantee* a definite return; and the risks of property ownership involved are borne exclusively by the issuing companies, which are required by law to possess a "reserve" to meet the guarantees which they make upon assuming the risk shifted to them. The "likeness," then, is exclusively verbal.

In any event, it is inconceivable that the 73d Congress, determined to stop the speculative abuses that had contributed to the great depression of the thirties, would have exempted from the "disclosure act" a scheme furnishing the public an opportunity to invest in common stocks and to win or lose depending on a combination of luck and the skill of the promoters. The "variable annuity" is the very kind of investment medium Congress aimed at when it adopted the Securities Act. To exempt this scheme because it wears the "annuity" label would sacrifice substance to form and frustrate the congressional purpose.

II

Respondents Are "Investment Companies" Under the Investment Company Act of 1940 and Must Register as Such

The Securities Act emphasizes protection of investors and the public interest at the moment securities are offered. The Investment Company Act extends that protection, in certain investment situations, after the sale has taken place. The respondent companies are subject to the latter as well as the former.

Like the Securities Act, the Investment Company Act is concerned with substance rather than form. The Act defines an "issuer" as "every person who issues or proposes to issue any security, or has outstanding any security which it has issued" (§ 2(a)(21), 15 U. S. C. § 80a-2(a)(21)). And an "investment company" is defined by the Act as an issuer that is

> "(1) * * * engaged primarily * * * in the business of investing, reinvesting, or trading in securities"
>
> *or*
>
> "(3) * * * engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) * * *."[1]

An issuer conforming to these descriptions, even one chartered as an insurance company, if it is not in fact an "insurance company" as defined in § 2(a)(17) of the Act, much register with the SEC as an investment company under § 8 of the Act (15 U. S. C. § 80a-8) and obey the

[1] These definitions of an "investment company" are contained in §§ 3a(1) and 3a(3) of the Act, respectively, 15 U. S. C. §§ 80a-3a(1) and (3) (Appendix A, *infra*).

other provisions contained therein designed to protect buyers and holders of its securities and the public interest.

Manifestly the respondents are engaged in the business of investing, reinvesting, owning, holding and trading in securities. Their skill in investing so as to defeat the effect of inflation, indeed, is the essence of their "sales pitch". They have retained an investment adviser to help them (R. 513). Investing and trading in securities is their principal business, for they do virtually nothing else (except sell to the public shares in their investment pool). But it is not even necessary to quibble about whether investing is their "primary" business, because far more than 40 per cent of their assets are, or are proposed to be, in common stocks, which would bring them within part (3) of the quoted definition even if their admitted "investing" was not their "primary" business.

Respondents' claim to be exempt from the requirements of this Act is analyzed *infra*.

III

Risk-Shifting is an Indispensable Element of "Insurance" in its Commonly Accepted Sense

The foregoing discussion shows that "variable annuities" and their issuers are subject to registration in the public interest unless specially exempted. The pivotal issue in this case, therefore, is whether the "variable annuity" contract is "insurance" within the meaning of that term as employed in the exemption provisions of the Securities Act of 1933 (§ 3(a)(8)),[1] the Investment Com-

[1] See. 3(a)(8): "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."

pany Act of 1940 (§ 2(a)(17)[1] and § 3(c)(3)), and the McCarran-Ferguson Act.[2] The term "insurance" is not defined in any of these Acts or their legislative histories. There are no reported cases in which the meaning of the term in any of the Acts is construed. Necessarily, then, the language and purpose of the Acts are virtually the only basis for determining what the Congress intended to exempt. Under such circumstances, this Court has held that the term "insurance" must be taken to have been used in a statute in its "commonly accepted sense."[3]

A

The "Commonly Accepted Sense" of the Term "Insurance"

This Court has already construed the meaning of the term "insurance" when used by the Congress in a statutory enactment without definition. In so doing it said:

> "Historically and commonly insurance involves risk-shifting and risk-distributing. * * * That these elements of risk-shifting and risk-distributing are essential to a life insurance contract is agreed by courts and commentators."[4]

The same conclusion was reached by the Court of Appeals for the District of Columbia Circuit in another leading case which reviewed and analyzed a multitude of authorities. In construing the meaning of the term "insur-

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[1] Sec. 2(a)(17): "'Insurance company' means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such."

[2] This Act exempts only "the business of insurance" from Federal regulation.

[3] *Helvering v. Le Gierse*, 312 U. S. 531, 540 (1941).

[4] *Helvering v. Le Gierse*, 312 U. S. 531, 539 (1941). It is respectfully suggested that the indispensable legal element of insurance is risk-shifting; and that risk-distributing almost always accompanies commercial insurance merely because it is economically the soundest way for an insurer to provide for payment of the risks that have been shifted to it.

ance" when used in the insurance laws of the District of Columbia without statutory definition, that court said:

> "It is unnecessary for us to attempt formulation of an all-inclusive or exclusive definition of insurance or of indemnity, or to distinguish them sharply. While the basic concepts are not identical and each has varied legal usages, they have common and primary elements which are controlling here. Fundamentally each involves contractual security against anticipated loss. Whether the contract is one of insurance or of indemnity there must be a risk of loss to which one party may be subjected by contingent or future events and an assumption of it by legally binding arrangement by another. Even the most loosely stated conceptions of insurance and indemnity require these elements. Hazard is essential and equally so a shifting of its incidence. If there is no risk, or there being one it is not shifted to another or others, there can be neither insurance nor indemnity. Insurance also, by the better view, involves distribution of the risk, but distribution without assumption hardly can be held to be insurance."[1]

Perhaps the best-known and most-quoted common-law definition of "insurance" is that of the Supreme Judicial Court of Massachusetts in the leading case of *Commonwealth v. Wetherbee*, 105 Mass. 149 (1870):

> "A contract of insurance is an agreement, in which one party, for a consideration, (which is usually paid in money, either in one sum or at different times during the continuance of the risk,) promises to make a certain payment of money upon the destruction or injury of something in which the other party has an interest. * * * All that is requisite to constitute such a contract is the payment of consideration by the one, and promise of the other to pay the amount of the insurance upon the happening of injury to the subject by a contingency contemplated in the contract."[2]

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[1] *Jordan v. Group Health Ass'n*, 107 F. 2d 239, 244-245 (1939).

[2] Prior to the enactment of § 41 of the New York Insurance Law defining the term "insurance contract," the New York Court of Appeals, in *Ollendorf Watch Co. v. Pink*, 279 N. Y. 32, 17 N. E. 2d 676 (1938), approved and adopted the Massachusetts common-law definition.

Webster's Collegiate Dictionary (5th ed. 1946) defines "insurance" as:

> "* * * a contract whereby one party undertakes to indemnify or guarantee another against loss by a contingent event; also, *the business of making* such contracts * * *."

Thus, courts and lexicographers are all agreed that in the "commonly accepted sense" the indispensable element of "insurance" is the shifting of a risk of loss, which will be incurred upon the happening of an insurable contingency, from the person subject to such loss to another.[1]

B

A Contract Does Not Become One of "Insurance" Merely Because It Contains Some of the Trappings of Insurance

The cases and authorities discussed above show that the essence of insurance is a risk of loss which is shifted from one person to another. In the absence of this indispensable element the presence in a contract of details customarily associated with insurance cannot make the contract one of insurance no matter how artfully such details may be used. Labels, forms and terms, while they may confound the unwary and uninquisitive, are not controlling.[2]

That the printing of a contract in a form that looks like an insurance policy and the use of insurance terms therein do not make a contract "insurance" was long ago decided by this Court. In *Helvering v. Le Gierse*, 312 U. S. 531, 541 (1941), this Court said:

> "It is true that the 'insurance' contract looks like an insurance policy, contains all the usual provisions of

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[1] Statutory definitions are irrelevant. The Congress or the state legislatures can, of course, define the term in any statute in which they intend that it have meaning other than its "commonly accepted sense."

[2] *Cf. SEC v. C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943); *SEC v. W. J. Howey Co.*, 328 U. S. 293 (1946).

one * * * [but] * * * Certainly the mere presence of the customary provisions does not create risk * * *."

Contained in the "variable annuity" contract are the terms "Cash Value" and "Policy Loans."[1] In a true insurance contract these values are fixed and guaranteed. In the "variable annuity" contract they have reference to unforeseeable, speculative, non-guaranteed, future current value of "accumulation unit" shares purchased by and credited to the account of the contract holder. The true insurance which *may* be included in VALIC's contract (5-year decreasing term life insurance and permanent and total disability) has no cash or policy loan value (R. 289).

"Incontestability," "Suicide," and "Protection from Creditors" provisions apply only to true life insurance and have no applicability to the "variable annuity" contract.[2] A "Grace Period" is required by law in true insurance contracts for the protection of the insured;[3] in the "variable annuity" it is only an extension of time for payment which contracting parties can, by agreement, insert in any contract. Failure to pay before the end of the so-called "Grace Period" does not terminate the purchaser's participation in the investment fund (as it would forfeit an insurance policy). He retains ownership of the "accumulation unit" shares which he has purchased and their value continues to fluctuate with VALIC's investment experience.

The provisions that are of the essence of the "variable annuity"—"Net Investment Rate and Net Investment Factor," "Accumulation Unit," "Annuity Units," "Annuity Unit Value,"[4] are not found in insurance nomenclature in either form or substance. VALIC's own actuary,

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[1] Pls. Exh. No. 1, pars. 14-15 (R. 572).
[2] Pls. Exh. No. 1, pars. 10, 24, 26 (R. 570, 573, 574).
[3] MACLEAN, LIFE INSURANCE (8th ed. 1957) 178-179.
[4] Pls. Exh. No. 1, pars. 18-21 (R. 573).

who testified that he had been retained by at least 150 insurance companies (R. 523), said that in all his experience he had never seen such terms in an insurance contract (R. 554-555).

Mortality tables, which project rates of death per age group, are complied on the basis of past experience and anticipated increases of longevity. They are used by others than insurers—courts, school boards, public utilities, municipal planners—in forecasting death rates and life expectancy. Insurers use such tables in conjunction with future estimated income (generally referred to as "interest")[1] as a kind of cost accounting device in much the same way that a manufacturer or retailer estimates his costs to fix his selling price (R. 283).[2] The insurer then offers for sale its contract with *guaranteed* insurance coverage for a self-determined consideration. Insofar as an insured in concerned the insurer, upon the occurrence of the contingency insured against, is legally obligated to indemnify him or make payment in the amount specified in the contract notwithstanding that the actual death rate among the insured group may not have agreed with the insurer's estimate made prior to the execution of the contract, or that the insurer may have failed to realize what it had anticipated would be its investment income.[3]

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[1] "The term 'interest' is conventionally used to mean 'income on investment,' although a portion of that income is in other forms, such as dividends or rent" MACLEAN, LIFE INSURANCE (8th ed. 1957) 147, n. 1.

[2] See "Assumptions Underlying Rate Computations" in HUEBNER, LIFE INSURANCE (4th ed. 1950) 194-198.

[3] "* * * a company in computing premiums must estimate its experience for at least twenty years and, in the vast majority of cases, for much longer since the company must continue the contract in force for so long as the insured pays the premiums required by the contract. Furthermore, the company cannot change the premium on any policies in force, and if policies have been issued at inadequate premiums, these contracts must be carried at a loss. If the deficit cannot be made up out of surplus, of course, the company will become bankrupt." HUEBNER, LIFE INSURANCE (4th ed. 1950) 193. Accord, MACLEAN, LIFE INSURANCE (8th ed. 1957) 93-112, 535-539.

To fulfill its contractual obligation to the insured, the insurer is required by the states to comply with a legal reserve system which will demonstrate to the state regulatory body that the insurer has (and keeps) sufficient assets on hand which, with future premium income and an acceptable *specified* rate of investment income, will assure, insofar as law can make it so, that the insurer will be financially able to liquidate its contractual assumption of risks as they come due.[1] The nature and purpose of legal reserves has been succinctly summarized by the Court of Appeals for the District of Columbia Circuit in *Jordan v. Group Health Ass'n*, 107 F. 2d 239, 251 (1939):

> "The object of these [required reserves and regulation of finances] is protection of the insured and thus of the public against the insurer. They assume separateness of identity, with consequent diversity of ownership and possible antagonism of interest between them as well as definite assumption of liability, legally enforceable, by the insurer to the insured. Such re-

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[1] HUEBNER, LIFE INSURANCE (4th ed. 1950) 247 says: "The state, in establishing a method of valuing life insurance contracts, sets certain standards of interest and mortality that can safely be realized and then says, in effect, that any company is solvent if on the basis of calculations made with these standards its future premiums plus its reserve fund will enable it to pay all claims. The minimum standard set by state law in most instances are a 3½ per cent interest rate and mortality according to the *American Experience Table* for policies issued prior to 1948 and the *CSO Table* with 3½ per cent interest for later issues" (italics in original). See also MACLEAN, LIFE INSURANCE (8th ed. 1957) 114-145.

For a technical explanation, with illustrations, of how insurance reserves are computed, see WIGHTMAN, LIFE INSURANCE STATEMENTS AND ACCOUNTS (1952) 559-589.

The "legal standard of valuation" in the District of Columbia provides (§ 35-701 (a), D. C. Code (1951)):

> "The Superintendent shall annually value, or cause to be valued, the reserve liabilities (hereinafter called reserves) for all outstanding life-insurance policies and annuity and pure endowment contracts of every life-insurance company doing business in the District * * *, *specifying* the mortality table or tables, *rate or rates of interest* and methods (net level premium method or other) used in the calculation of such reserves. All such valuations made by him or by his authority, shall be made upon the net premium basis * * *."

VALIC cannot comply with this requirement of law. While its "variable annuity" contract mentions the Progressive Annuity Mortality Table, it does not specify or guarantee any "rate or rates of interest" after the first payment. For this reason it will have to substitute some "artificial assumption" for the "rates" required by the statute (testimony of Hooker, R. 191, 274-275).

quirements can have meaning, purpose and useful effect only in relation to definite and binding obligations as to which, in their absence there is danger of default. They are entirely inappropriate where no such risk is assumed * * *."[1]

VALIC's so-called "reserves" are not absolute in amount based on *fixed* future obligations, but vary with investment experience and investment taxes, for the effect of which VALIC takes no responsibility. They are therefore not insurance reserves.

C

A Life Contingency Factor Does Not Make a Contract "Insurance"

While the uncertainty of duration of life creates insurable contingencies, they cannot be said to be insured against unless the risk of loss to the insured attendant on the happening of the contingency is shifted to and guaranteed by an insurer.

There are many contracts in which a life contingency is a factor in that it is determinative of the term of the contract; *e. g.*, marriage, partnership and employment. No one would say that such contracts are insurance.[2]

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[1] It is common knowledge that the depression of the 30's proved the soundness of legal reserve requirements for life insurance. Notwithstanding the economically disastrous losses in the market value of equities, the business of life insurance was liquid and paid off the guarantees of its contracts; not only losses incurred upon the happening of the contingencies insured against, but also guaranteed policy "cash values" and "loan values".

[2] VALIC's contention that "variable annuity" contracts can be sold only by life insurance companies because they include a life contingency factor is unsupported by Federal law. Insofar as Federal law is concerned the contract, being a security, can be sold by anyone, including life insurance companies, provided he complies with the Federal regulatory scheme which the Congress has established for the protection of the public, the investor and in the public interest. Whether an insurance company is permitted to sell securities is, of course, dependent upon its charter and the various state laws prescribing limitations on activities of such companies. Stock insurance companies offering their own stock for sale to the public through the mails and use of the instrumentalities of interstate commerce comply with the registration requirements of the Securities Act. See Report of the Securities and Exchange Commission on S. 2054 (Feb. 11, 1957), 85th Cong., 1st Sess.

D

Approval of a Contract by an Insurance Commissioner Does Not Make It "Insurance" in the "Commonly Accepted Sense"

Insurance commissioners for the various states are administrative officials having prescribed and circumscribed statutory authority which varies from state to state. What a state, in the exercise of its sovereign power, may choose to encompass within a statutory definition of the term "insurance" need not be confined to the "commonly accepted sense" of the term.

There is nothing in the Federal securities laws or the McCarran-Ferguson Act which even suggests that Congress gave the state insurance commissioners the right to determine that a given contract is one of "insurance" and thereby to exempt it or its issuer from compliance with the securities laws. This would be a most extraordinary power, since it would make state officials (with no jurisdiction over securities) the final arbiters as respects the coverage of the Securities Act and the Investment Company Act. It could hardly have been the intent of Congress that its nationwide securities legislation should govern a contract issued in the state of Connecticut, but should not apply at all to a substantially identical contract issued in the state of Arkansas. We submit that this power cannot be implied. If it had been intended by Congress, it would have been stated in explicit terms.[1]

That the opinion of the Superintendent of Insurance for the District of Columbia is not conclusive as to whether a contract is one of insurance has been firmly established by the Court of Appeals for the District of Columbia Cir-

[1] *Cf. National Casualty Co. v. Federal Trade Commission*, 245 F. 2d 883, 887 (6th Cir. 1957), *aff'd*, 357 U. S. 560 (1958).

cuit. In *Drake v. United States* ex rel. *Bates*, 30 App. D. C. 312, 318-319 (1908), the court, in referring to the powers of the Superintendent, said:

> "It is quite clear that no provision of the law conferred or attempted to confer upon the superintendent of insurance the power to make and enforce an interpretation of the laws relating to insurance companies * * * Such power is a judicial one, that can be exercised by the courts alone."[1]

The court in effect reaffirmed this statement of the law when in 1939 it held that, notwithstanding the Superintendent's conclusion that an appellee corporation was engaged in the business of insurance, he had no jurisdiction because the contracts involved were as a matter of law not "insurance."[2]

This Court, in the *Le Gierse* case and its companion case, held that insurance policies and annuity contracts were not "insurance" notwithstanding that (as the facts of the case show) they had been approved by a state insurance commissioner and sold by an entity chartered as an insurance company.[3]

E

"Variable Annuities" Cannot Be Compared to Participating Insurance Policies

Throughout the years, with changing economic conditions, new and broader types of insurance have been devised and offered for sale by insurers. All these new types, however, possess the indispensable element of risk-shifting, which differentiates "insurance" from "variable annuities."

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[1] The statutory authority of the office of the Superintendent of Insurance is set forth in D. C. Code (1951) §§ 35-101, -102, -401.

[2] *Jordan v. Group Health Ass'n*, 107 F. 2d 239 (1939).

[3] *Helvering v. Le Gierse*, 312 U. S. 531 (1941); *Keller v. Commissioner of Internal Revenue*, 312 U. S. 543 (1941).

Insurance companies are classified as stock or mutual companies.[1] Stock companies "issue chiefly nonparticipating policies (i.e., without dividends to policyholders); but many also issue participating policies (at higher premium rates), most of the surplus earnings from which are paid to the policyholder * * * Mutual companies issue participating policies, which provide for adjustment of cost from surplus earnings (dividends)."[2]

Mehr, an expert witness for VALIC, testified:

> "Now, dividends in a participating company are so ingrained in the ideas of the policyholder that the companies use an interest assumption that will yield a dividend to the policyholder * * *" (R. 470).

Dividends on a participating policy are paid out of surplus funds which may result from, *inter alia,* favorable mortality experience, realization of interest at a rate higher than that assumed, loadings in the premium rate proving to be more than sufficient to provide for expenses and contingencies, and from capital gains.[3] In the insurance business, "the word 'dividend' is to some extent a misnomer, the 'dividend' on a participating policy being rather in the nature of a refund and not a return on an investment as the term is generally used in commercial transactions."[4]

While the amount of "premium" paid by an insured may be reduced by insurance "dividends," this does not affect the risk of loss shifted to and assumed by the insurer (whether it be a stock or mutual company) when it guaran-

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[1] VALIC is a stock company (R. 284). Excerpting from the text of its expert witness Maclean (LIFE INSURANCE (8th ed. 1957) 18): "It is formed primarily for the purpose of earning profits for the stockholders who own and control the company."

[2] MACLEAN, LIFE INSURANCE (8th ed. 1957) 18; accord, HUEBNER, LIFE INSURANCE (4th ed. 1950) ch. XXIX.

[3] MACLEAN, LIFE INSURANCE (8th ed. 1957) 147; HUEBNER, LIFE INSURANCE (4th ed. 1950) ch. XXII.

[4] MACLEAN, LIFE INSURANCE (8th ed. 1957) 148, n. 1; accord, HUEBNER, LIFE INSURANCE (4th ed. 1950) 300.

tees to pay upon the happening of the specified insurable contingency. VALIC did not, and indeed it could not, introduce any evidence to the contrary.

Insurance "dividends" affect premium rates, but have no effect whatever on the risk shifted to the company. Its positive guarantee of payment remains unaffected whether it pays large policy "dividends" or none at all.

VALIC's "variable annuity" investment scheme, which does not provide for risk-shifting, does not affect the consideration paid by the contract holders, but only their entitlements (which are conditioned on VALIC's investment experience). Thus, insurance policies that pay "dividends" and the "variable annuity" scheme cannot be compared.

IV

The "Variable Annuity" Contract is not Insurance Because it Lacks the Indispensable Element of Risk-Shifting

A

The Risk Shifted by Insurance or an Annuity

Insurers, in connection with life insurance and annuity contracts, insure against the hazards attendant on the uncertainties of the life span. The two types of contracts are equated in the insurance concept because of the elements of *certainty* and mortality that inhere in both.

An insurer that sells both life insurance and annuities is selling certainty to its policy holders, despite the fact that each individual has a life of uncertain duration; certainty that the dependents of the insured will have a definite amount of money if he dies; and certainty that

the annuitant will have a *fixed* dependable income after a certain age for the continuing years of his life.[1] From the viewpoint of the insured, life insurance is assurance against loss from early death; annuity, loss from longevity.[2]

Unless the risk of loss attendant on death or longevity is contractually shifted to and assumed by an insurer, the contract, notwithstanding its label or the corporate charter of the issuer or any other criterion, is not insurance. From what source or through what economic methods the insurer acquires the money to meet its contractual obligations is no part of an "insurance" contract. The contract fixes only the insurer's obligation to pay.

B

The "Variable Annuity" Does Not Shift the Risk of Loss Attendant on the Contingency of Longevity

In the accumulation period, during which the purchaser of a "variable annuity" contract is making payments to VALIC, there can be no question that VALIC's operations are those of an investment company. The contract purchaser is then an investor in every sense of the word. The purchaser supplies the capital, purchases shares in an investment fund which he may cash in at any time at current value, and is dependent upon VALIC's exclusive

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[1] Accord, HUEBNER, LIFE INSURANCE (4th ed. 1950) 130-132.

[2] HUEBNER, LIFE INSURANCE (4th ed. 1950) defines "life insurance" and "annuities" thus:

> "From the standpoint of the individual, however, life insurance may be defined as consisting of a contract, whereby for a stipulated compensation, called the premium, one party (the insurer) agrees to pay the other (the insured) or his beneficiary, a *fixed* sum upon the happening of death or some other specified event" (p. 3).
>
> * * *
>
> "An annuity therefore represents the purchase of a *fixed* income (monthly, quarterly, semi-annually, or annually) and the general purpose of the contract is seen to be the reverse of that accomplished under life insurance" (p. 91).

management, operation and control of the fund.[1] The value of his shares fluctuates with the fund's investment experience. It is a purely speculative venture in which the purchaser has only the hope of gain and bears the risk of loss.[2] Does this investment venture become "insurance" because the participant *elects* at a future time to become a party to the "variable annuity" period of the contract? It does not; for if he so elects he agrees to purchase shares ("annuity units") in the same investment fund, at current value, and for the term of the contract (from date of election to date of death of the participant, or other optional term) and VALIC agrees to make him an uncertain payment, the amount of which is dependent upon its future, month to month, investment experience resulting from its exclusive management, operation and control of the investment fund.[3]

The proof is clear that during this "variable annuity" period VALIC does not guarantee that *any* payments will

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[1] VALIC has in the past objected to our characterization of the cash and securities in its hands as a "fund" in which contract holders have aliquot shares. This objection is easily met by reference to VALIC's own sales literature of record herein. See, *e.g.*, Pls. Exh. No. 20, R. 761-767 at 763: "If the equities held in the *fund* increase in market value, the value of the units will be increased proportionately."

[2] Mr. Harry Prankard, with long experience in the investment company business as a certified public accountant and an executive (R. 307-308), demonstrated in his testimony that the formula specified in the "variable annuity" contract for determining the value of shares and the method employed by investment companies have the same end result. VALIC uses percentage increase or decrease; investment companies dollar increase or decrease (R. 309-319).

[3] Compare the classic description of the rights of an insurance policy-holder appearing as follows in *People v. Security Life Ins. & Annuity Co.*, 78 N. Y. 114, 123 (1879):

> "The fund produced by the payment of all the premiums does not in any sense belong to the policy-holders but belongs exclusively to the company; and the policy-holders are interested in it in the same way only that the creditors of any other corporation are interested in its fund"

with the following from the District Court's opinion, 155 F. Supp. at p. 524 (R. 85):

> "Whereas the money paid for conventional insurance becomes the absolute property of the insurance company, the money paid for a variable annuity goes into an investment fund which becomes, by operation of law if not by express terms of the contract, a trust fund for the equitable interests of the contract holders."

See also 8 COUCH, CYCLOPEDIA OF INSURANCE LAW, §§ 2043-2045.

be made to the shareholders or that the capital which they have supplied may not be dissipated by investment losses.

References in VALIC's "variable annuity" contract to the Progressive Annuity Table at 3½% and a provision that payments to shareholders will not be decreased because mortality of shareholders may be less than indicated by the Table are meaningless when analyzed. The Progressive Annuity Table at 3½% is used by VALIC for one purpose only: to determine the first monthly payment to be made to the contract holder, which in all contracts is less than $10 per $1000 of capital investment.[1] From this point on, the impressively voluminous tables of payments set forth in the contract (R. 568-569) have no application. The total *first* monthly payment thus determined is then divided by the current value of an "annuity unit" share and the resulting number of shares is purchased by the investor and credited to his account. Ownership of these shares, with their uncertain future monthly value, is all that the purchaser receives for his capital payment.[2] Subsequent payments for the term of the contract, *if any*, depend upon VALIC's investment experience.[3]

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[1] This could hardly be held to be a substantial risk assumed by VALIC. *Cf. Keller v. Commissioner of Internal Revenue*, 312 U. S. 543 (1941).

[2] Reference to a mortality table is not necessary to effectuate the "variable annuity" scheme. Promoters could establish any arbitrary table of first monthly payment, at any specified age, per $1000 invested and employ VALIC's formula of dividing the total first monthly payment by a current value of "annuity unit" shares and thus determine number of shares purchased. Whether the VALIC formula (which is camouflaged by reference to a mortality table) or an arbitrary table is employed does not affect the principle of the transaction.

[3] VALIC has never earned as much as 3½% on its funds, so far as the record shows (Pls. Exh. No. 4 (R. 647-652)). Counsel for VALIC conceded this (R. 545-546).

If VALIC begins with a fund which with a 3½% "net investment rate" is sufficient to maintain level payments to a group of individuals, then if the net investment return is actually zero instead of 3½%, no investment return will in fact the distributed and the successive payments will become smaller and smaller. Since there is no investment income to be distributed, only the original fund will be distributed; and the original fund will be lessened by VALIC's management fee of 1.8% per annum and such amounts as it may

(Footnote continued on following page.)

A statement in the contract that VALIC guarantees that the dollar value of "annuity unit" shares will not be affected by "variations in mortality experience" (Pls. Exh. No. 1, par. 22 (R. 573)) is redundant.[1] By specific provision in its contract VALIC agrees to make monthly payments on the basis of "annuity unit" shares held times their current value (*Id.*). By operation of this provision VALIC takes the calculated risk that the number of outstanding shares may require it to dip into its surplus, if any, or the capital contributions of its shareholders.[2] This is a risk taken by any entrepreneur; it is not an "insurance" risk in the sense explained in the *Le Gierse* case.[3]

That risk-distributing, even coupled with a life contingency, does not make a contract insurance may be demonstrated by an illustration:

A person who buys a pari-mutuel ticket at a race track participates in a scheme for risk-distribution. If the track

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(Footnote continued from preceding page.)
be required to pay for investment taxes. If there is actual capital loss on investments, in excess of income, then it is obvious that not all of the original fund will in fact be distributed to the contract holders, since part of it will never be available for distribution, having been lost through investment misfortune.

Under the usual form of life annuity contract, so long as the insurer is solvent, the contract holder gets the same payment, no matter what may happen to the insurer's investments. The insurer may become insolvent by reason of adverse investment experience alone, but VALIC can *never* become insolvent by reason of adverse investment experience alone. It is the contract holders who will bear the investment losses; and if these are large enough, the individual's losses contingent upon survival to respective payment dates will not be indemnified as *guaranteed* in an annuity contract.

[1] Such a statement cannot be found in a true annuity or life insurance contract, since the risk of adverse mortality experience is a calculated one taken by an insurer. An insurer's obligation to the insured is contractually fixed upon the happening of the insurable contingency.

[2] The capital contributions of VALIC's stockholders have been invested in securities having a par value of $211,000 which the Superintendent of Insurance has certified "are worth not less than $200,000" (Def. Exh. No. 12 (R. 822)).

[3] "It is not enough to show that the insurance company assumed 'some' risk. A bank assumes a risk when it accepts a depositor's funds and invests them. The investment may prove to be an unsafe one, or the bank may have agreed to pay the depositor a higher rate of interest than it can profitably earn on the funds it invests. Indisputably this is a risk. But it is not a insurance risk in the sense explained in the *Le Gierse* case." *Keller v. Commissioner of Internal Revenue*, 312 U. S. 543, 544 (1941).

should require, as a condition of collecting (should he prove lucky enough to have his horse win), that he be alive and personally present the ticket at the pay-off window, he would also participate in a scheme involving a life contingency. But it would not be insurance. VALIC's "variable annuity" contract differs in detail but not in substance from the illustration. Both entail speculation—in the pari-mutuel on a horse winning a race; in the "variable annuity" on VALIC's good luck or skill with its investments. In both, the availability of a sum to collect is contingent not on survival alone but on a speculative chance as well. In both, the amount collected, *if any*, is not related to or indemnification for any loss occasioned by the insurable contingency of continuing life beyond a specified age.

In the "variable annuity" period the "annuity unit" shareholder is not assured that he will have a fixed, dependable income, or any income, from his "variable annuity" for the remainder of his life. He foregoes this benefit in return for the gamble that he will realize from the speculative "variable annuity" scheme a return greater than that he would be guaranteed under a conventional annuity. As a part of the gamble he remains subject not only to the risk of loss attendant on longevity, but also loss of his capital investment. Both lower courts recognized this.[1]

VALIC has been heard to argue that the contract it sells is an "annuity" because the death of the purchaser, a short time after he *elects* to participate in the "variable annuity" period, will prevent his receiving more than a nominal return of his capital. VALIC asserts that this is one of the characteristics of "insurance." This is superficial. The purchaser of an "annuity" buys guaranteed

[1] See Statement of Facts, *supra*, at pp. 17-19.

protection. He is willing to take the financial risks of early death in return for the guarantees of an insurer. The purchaser of a "variable annuity," however, gets no guaranteed protection. He takes a chance whether he is going to die immediately or live for many years.

"Risk-shifting" is legally indispensable to insurance. The potential loss which a conventional annuity shifts to an insurer is not shifted to or assumed by VALIC. The purchaser of VALIC's "variable annuity" contract remains saddled with the risks of longevity risks of equity ownership. Therefore, the "variable annuity" contract is not insurance.

V

The "Variable Annuity" is not an Annuity Contract

We have shown above that the "variable annuity" contract is not insurance. Neither is it an "annuity contract" within the meaning of § 3(a)(8) of the Securities Act of 1933.[1] The same rules of statutory construction apply to this term as to the term "insurance": each was used by Congress "in its commonly accepted sense."

The essence of an *annuity* is (a) periodic payment *of* (b) a *fixed* sum. The authorities to this effect have recently been assembled and reviewed at length in connection with "variable annuities."[2] At this point we need cite only two of the historical and one of the recent definitions of "annuity."

In *Booth v. Ammerman*, 4 Bradford Surr. 129 (N. Y. 1856), the testator had bequeathed to A "the interest upon

[1] Appendix A, *infra*, p. 58.

[2] See *Bellinger, et al.*, "The Meaning and Usage of the Word 'Annuity'" 9 Journal of the American Society of Chartered Life Underwriters (1955) 261, for citation and discussion of the relevant case law and standard insurance texts.

$1500," payable annually during her widowhood. The Court held that this bequest was *not* an *annuity,* saying (at pp. 133-134):

> "An annuity is a stated sum per annum, payable annually unless otherwise directed. It is *not* income or *profits,* nor *indeterminate* in amount varying according to the income of profits, though a certain fund may be provided, out of which it is to be payable * * *"
>
> [If the payment] "is not a stated sum, but may be more or less, according to the earnings of the capital * * * it does not possess the characteristic of an annuity * * *"

This definition has frequently been adopted and repeated in later decisions, both in New York and in other jurisdictions.

In *Peck v. Kinney,* 143 Fed. 76, 80 (2d Cir. 1905), the court, determining whether a property interest should be taxed as a life estate or an annuity, held that an *annuity* had been created because:

> "The essential element is the certainty of the amount to be paid periodically at a certain rate per annum or in a certain aggregate annual amount."[1]

In 1957 the Supreme Court of Errors for the State of Connecticut expressed itself clearly to the same effect in connection with "variable annuities":

---

[1] The State of New York now has a statutory definition which reads:

> "'Annuities' meaning all agreements to make periodical payments where the making or continuance of all or of some of a series of such payments, or the amount of any such payment, is dependent upon the continuance of human life, except payments made under the authority of paragraph one." N. Y. Insurance Law § 46, subdivision 2.

In construing and applying this statutory definition, the Supreme Court of New York, recognized the distinction between the definition and the commonly accepted meaning of the term "annuity" when it stated:

> "The Court agrees with the Attorney General's statement that 'The words "periodical payments" do not necessarily entail only fixed sums payable on specified dates'." *In re Supreme or Cosmopolitan Council of Brotherhood of Commonwealth,* 193 Misc. 996; 86 N. Y. S. 2d 127, 130 (1938).

VALIC's reliance on this case as support for its argument that it offers an "annuity" in the ordinary sense of the word is therefore mistaken.

> "* * * the dollar return from the annuity units would fluctuate with the value and the amount of return from the corpus of the fund from which the annuities are paid. We have said that an annuity is a yearly payment of a certain sum of money granted to another in fee, or for life, or for a term of years, charging the person of the grantor only. It is a stated sum payable annually. [Cases cited.] Insurancewise, it has the same meaning. 1 Appleman, Insurance Law & Practice, Secs. 81; 1 Couch, Insurance, p. 38. The policy to be issued under the [variable] annuity option would provide for the payment, not of a fixed amount of money, but of an uncertain sum, which is quite different from the legal concept of the word 'annuity'."[1]

The term "annuity," by established definition and long usage, has thus been universally understood to denote *a fixed sum payable periodically.* Since a "fixed sum" cannot be a "variable sum," the coined name "variable annuity" presents a contradiction in terms.

VI

The "Variable Annuity" Contract and its Issuers are not Exempted From Compliance With the Federal Securities Laws by Those Laws or by the McCarran-Ferguson Act

A

The Securities Laws

Section 3(a)(8) of the Securities Act of 1933[2] and § 3(c)(3) of the Investment Company Act of 1940, which must be read with the definition of "insurance company" in § 2(a)(17) of that Act,[3] list conjunctive conditions that must be met to qualify for exemption.

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[1] *Spellacy v. American Life Ins. Ass'n*, 144 Conn. 346, 355, 131 A. 2d 834, 839.

[2] Appendix A, *infra*, p. 58.

[3] Appendix A, *infra*, p. 62.

In the Securities Act these conditions are:

1. The contract must be an "insurance policy" * * * or "annuity contract" * * *; *and*

2. Issued by "a corporation subject to the supervision of the insurance commissioner * * * of any State * * * or the District of Columbia."

In the Investment Company Act it is required that an "insurance company," to be exempt under § 3(c)(3), meet the definition of that term in § 2(a)(17) of the Act, which provides that:

1. The company must be "organized as an insurance company," *and*

2. The company's "primary and predominant business activity [must be] the writing of insurance * * *," *and*

3. The company must be "subject to supervision by the insurance commissioner of a State * * *."

VALIC and its "variable annuity" contract fail to qualify for exemption under either Act because:

A. Under the Securities Act the "variable annuity" is neither "insurance" nor an "annuity contract" within the meaning of those terms as used in the Act, and

B. Under the Investment Company Act VALIC's admittedly "primary and predominant business activity" is "the offering for sale" and sale of "variable annuity" contracts, not "the writing of insurance."[1]

[1] It is conceded that VALIC is chartered as an insurance company.

B

The Offering for Sale and the Selling of "Variable Annuity" Contracts is Not "The Business of Insurance"

The McCarran-Ferguson Act exempts from Federal regulation, in a consistently repeated phrase of limitation, "*the business of insurance.*" Research has failed to disclose any reported case in which the meaning of the phrase was at issue or construed by the Federal Courts. Neither the Act nor its legislative history defines it.[1]

---

[1] The impetus giving rise to consideration by the Congress and eventual passage of the McCarran-Ferguson Act was the decision of this Court in *United States v. South-Eastern Underwriters Assn.*, 322 U. S. 533 (1944). In that case the Court in effect overturned *Paul v. Virginia*, 8 Wall. 168 (1869), and a line of related subsequent cases which held that contracts of insurance are not commerce.

Relying on *Paul v. Virginia*, in the period from 1869 to 1944, the business of insurance, as conducted by insurance companies, involved practices concerning which the Congress had legislated in the exercise of its powers under the commerce clause.

The confusion and uncertainty in the insurance business generated by the *South-Eastern* case which the Congress felt compelled to remedy is best described by the following excerpts from the reports of the committees of both Houses of Congress:

> "Inevitable uncertainties which followed the handing down of the decision in the *Southeastern Underwriters Association* case, with respect to the constitutionality of State laws, have raised questions in the minds of insurance executives, State insurance officials, and others as to the validity of State tax laws as well as State regulatory provisions; thus making desirable legislation by the Congress to stabilize the general situation.
>
> "Bills attempting to deal with the problem were considered in both the House and the Senate during the Seventy-eighth Congress, but failed of enactment. Your committee believes there is urgent need for an immediate expression of policy by the Congress with respect to the continued regulation *of the business of insurance* by the respective States. Already many insurance companies have refused, while others have threatened refusal to comply with State tax laws, as well as with other State regulations, on the ground that to do so, when such laws may subsequently be held unconstitutional in keeping with the precedent-smashing decision in the *Southeastern Underwriters* case, will subject insurance executives to both civil and criminal actions for misappropriation of company funds." [S. Rep. No. 20, 79th Cong., 1st Sess., 1-2; H. R. Rep. No. 143, 79th Cong., 1st Sess., 2.]

Further, the House Report accompanying the legislation flatly stated:

> "*It is not the intention* of Congress in the enactment of this legislation to clothe the States with any power to regulate or tax *the business of insurance* beyond that which they had been held to possess prior to the decision of the United States Supreme Court in the South Eastern Under-

(Footnote continued on following page)

The McCarran-Ferguson Act was enacted in 1945. Its title states that it is "An Act to express the intent of the Congress with reference to the regulation of *the business of insurance.*"

Under these circumstances, the term "insurance" was obviously used by the Congress in its "commonly accepted sense." From this it logically follows that "the business of insurance" is the offering for sale and selling of contracts whereby the offeror undertakes to indemnify or guarantee another against loss by a contingent event. Inasmuch as VALIC's "variable annuity" contracts provide no such undertaking, the offering for sale and selling of such contracts cannot be held to be "the business of insurance." Therefore, VALIC cannot be held to qualify for exemption from Federal regulation by virtue of the McCarran-Ferguson Act, the applicability of which is expressly confined to "the business of insurance."

VII

The Lower Courts Misapplied Controlling Statutes in Exempting VALIC and the "Variable Annuity" Contract

The Findings of Fact of the trial court, in the light of existing law, show beyond question that it and the Court of Appeals erred in their conclusion that VALIC and its "variable annuity" contract are exempt from compliance with the Federal securities laws.

(Footnote continued from preceding page)
writers Association case." H. R. Rep. No. 143, 79th Cong., 1st Sess., 3.; see also 91 Cong. Rec. 1443.

The legislative history of the McCarran-Ferguson Act is found in the following: H. R. 3270 and S. 1362, 78th Cong., 1st Sess. (1943). Hearings Before Joint Subcommittees on the Judiciary on S. 1362, H. R. 3269 and H. R. 3270, H. R. Rep. No. 873, S. Rep. No. 1112; H. R. Rep. No. 68, 79th Cong., 1st Sess. (1945); S. Rep. No. 20, 79th Cong., 1st Sess. (1945); H. R. Rep. No. 143, 79th Cong., 1st Sess. (1945); and 91 Cong. Rec. 499-509, 1112-1122, 1443, 1470-1473, 1548-1559 (1945).

A

The District Court

We repeat that in its opinion the District Court said:

> "The logic of the law applied to the established facts seems to bring the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants [VALIC and EALIC] within the terms and plan of the Investment Company Act. This Court would feel constrained to so hold if it were not for the clear and explicit language of the McCarran Act and the fact that the defendants are licensed and registered by the Insurance Department of this District and the States where they operate."[1]

Then without making a finding that the "variable annuity" contract is "insurance" (the opinion implies that it is not)[2] and its sale "the business of insurance" the court concluded that because: (1) VALIC and EALIC are chartered as insurance companies; and (2) the contracts have been approved by the insurance commissioners of the District of Columbia and three states:

> "* * * this Court is constrained to hold that the broad, explicit and impelling language of the McCarran Act makes them exempt from Federal regulation unless and until Congress provides otherwise."[3]

As shown, *supra*, pp. 51-52, the McCarran-Ferguson Act applies only to "the business of insurance." It does not provide expressly or by implication that:

---

[1] 155 F. Supp. at p. 526 (R. 89).

[2] The District Court, toward the end of the trial, stated in effect that the "variable annuity" was not insurance but that the ultimate issue was what agency such contracts were to be regulated by. The court said:

> "* * * I think, there is a decided legal difference between the old line policy and your [VALIC's] new policy.
>
> "I am not deciding the ultimate question as to what agency are you [VALIC] amenable for regulation * * *." (R. 559).

Clearly the court confused the issue raised by the pleadings. It did not decide the basic issue as to whether the contracts are "insurance." Applicable regulation flows from this, not this from the regulation.

[3] 155 F. Supp. at p. 527 (R. 90-91). See also Conclusions of Law (R. 112).

(1) insurance companies are exempted from Federal regulation; or

(2) a state insurance commissioner's approval of a contract is conclusive that the contract is "insurance" and its sale "the business of insurance."

If the Congress intended that such criteria should be controlling it would easily have said so. Instead, by consistent repetition in the statute the Congress confined its applicability to "*the business of insurance*" and nothing else.

To hold that simply because an entity is chartered as an insurance company it can avoid Federal regulation of *any* activity that it can persuade a state insurance commissioner to approve is incompatible with the language and purpose of the Act. It would make any *one* insurance commissioner the arbiter of Federal jurisdiction insofar as insurance companies are concerned.[1]

B

The Court of Appeals

The Court of Appeals premised its affirmance on these statements:

1. The opinion of four insurance commissioners "that the business of VALIC is the business of insurance, is important"; and "we should not contradict the insurance commissioners";[2]

2. "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance com-

[1] If the "variable annuity" contract is insurance it is exempted from Federal securities regulation by §3(a)(8) of the Securities Act. Reference to the McCarran-Ferguson Act is not needed. If the contract is not "insurance" within the meaning of the Securities Act, then, certainly, its sale is not "the business of insurance."

[2] 257 F. 2d at pp. 204, 205 (R 891, 893).

missioner of a state subjects the business to his supervision, it is the business of insurance."[1]

We have already shown that 1, above, is of no probative value in resolving the issue of exemption from the Federal laws unless the contracts are "insurance" within the commonly accepted sense of the term.[2] Counsel for VALIC admitted this when, in conceding that there is disagreement in the insurance industry as to whether the "variable annuity" is a proper product to be sold by life insurance companies, he stated to the trial court that "this case is not going to be decided by a show of hands of Insurance Commissioners" (R. 518-519).[3] Likewise we have shown that the definitions in the Acts named in 2, above, require conjunctive conditions for qualifying for exemption and that one of the indispensable conditions in both Acts is that the contracts be "insurance." The court made no finding that this condition was satisfied. Contrariwise, the court implicitly found that the "variable annuity" contracts are not "insurance" when it could go no further than to say that the contract is a "novel" arrangement[4] which "resembles insurance" and its sale a "new business."[5]

---

[1] 257 F. 2d at p. 205 (R. 892).

[2] Regardless of approval of VALIC's "variable annuity" contracts by the insurance commissioner of West Virginia (one of the actions on which both lower courts relied) the Securities Commissioner of that state has brought action to enjoin the sale of such contracts within the state unless VALIC complies with the state's securities laws. *State of West Virginia ex rel. Edgar B. Sims, its Commissioner of Securities v. Variable Annuity Life Insurance Company of America, Inc.*, Circuit Court of Kanawha County, West Virginia, Docket No. 24,449. The case was tried on July 21-22, 1958 and the parties have submitted briefs. The court has the case under advisement.

[3] Compare with a table showing state legislatures in which bills have been introduced to permit insurance companies to sell "variable annuities" (Appendix B, *infra*, p. 67). Not one of the states has enacted such legislation. These bills make it clear that in none of these states do "variable annuities" qualify under general insurance laws:

[4] 257 F. 2d at p. 204 (R. 890).

[5] 257 F. 2d at p. 205 (R. 893).

The court concluded its opinion by suggesting that there is a demand for "variable annuities," and that this "new business" constitutes an "attempt to solve a problem badly in need of solution." This may be entirely true; but it is not relevant to proper disposition of the case. This action is not an attempt to extirpate "variable annuities." Petitioner contends only that these devices should be regulated as other investments are. If there is an economic need for "variable annuities" it can be satisfied within the framework of regulation provided by the Federal securities laws.

CONCLUSION

For the Reasons Stated it is Respectfully Submitted That the Judgment of the Court Below Should be Reversed.

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November 1958.

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APPENDIX A

Pertinent Provisions of Statutes

SECURITIES ACT OF 1933 AS AMENDED

AN ACT

To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

* * * * *

Sec. 2.[1] When used in this title, unless the context otherwise requires—

(1) the term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

* * * * *

[1] 48 Stat. 74, as amended, 15 U. S. C. 77b(1).

Sec. 3. (a)[2] Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

* * * * *

Sec. 3. (a)(8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

* * * * *

Sec. 5. (a)[3] Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

---

[2] 48 Stat. 76; 15 U. S. C. 77c(a)(8).
[3] 48 Stat. 77; as amended; 15 U. S. C., Supp. II, 77e.

(2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of sub-section (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

INVESTMENT COMPANY ACT OF 1940

AN ACT

To provide for the registration and regulation of investment companies and investment advisers, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Sec. 1. (a)[4] Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby found that investment companies are affected with a national public interest in that, among other things—

[4] 54 Stat. 789; U. S. C. 80a-1.

(1) the securities issued by such companies, which constitute a substantial part of all securities publicly offered, are distributed, purchased, paid for, exchanged, transferred, redeemed, and repurchased by use of the mails and means and instrumentalities of interstate commerce, and in the case of the numerous companies which issue redeemable securities this process of distribution and redemption is continuous;

(2) the principal activities of such companies—investing, reinvesting, and trading in securities—are conducted by use of the mails and means and instrumentalities of interstate commerce, including the facilities of national securities exchanges, and constitute a substantial part of all transactions effected in the securities markets of the Nation;

(3) such companies customarily invest and trade in securities issued by, and may dominate and control or otherwise affect the policies and management of, companies engaged in business in interstate commerce;

(4) such companies are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets; and

(5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors.

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission

made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves.

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

* * * * *

Sec. 2. (a)(17)[5] "Insurance Company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or

[5] 54 Stat. 793; U. S. C. 80a-2(a)(17).

any liquidating agent for such a company, in his capacity as such.

* * * * *

Sec. 2 (a)(21)[6] "Issuer" means every person who issues or proposes to issue any security, or has outstanding any security which it has issued.

* * * * *

Sec. 3. (a)[7] When used in this title, "investment company" means any issuer which—

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

* * * * *

Sec. 3. (c)[8] Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:

(3) Any bank or insurance company * * *

* * * * *

[6] 54 Stat. 793; 15 U. S. C. 80a-2(a)(21).
[7] 54 Stat. 797; 15 U. S. C. 80a-3(a).
[8] 54 Stat. 798; 15 U. S. C. 80a-3(c).

Sec. 7. (a)[9] No investment company organized or otherwise created under the laws of the United States or of a State and having a board of directors, unless registered under section 8, shall directly or indirectly—

(1) offer for sale, sell, or deliver after sale, by the use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person; or offer for sale, sell, or deliver after sale any such security or interest, having reason to believe that such security or interest will be made the subject of a public offering by use of the mails or any means or instrumentality of interstate commerce;

(2) purchase, redeem, retire, or otherwise acquire or attempt to acquire, by use of the mails or any means or instrumentality of interstate commerce, any security or any interest in a security, whether the issuer of such security is such investment company or another person;

(3) control any investment company which does any of the acts enumerated in paragraphs (1) and (2);

(4) engage in any business in interstate commerce; or

(5) control any company which is engaged in any business in interstate commerce.

* * * * *

Sec. 8. (a)[10] Any investment company organized or otherwise created under the laws of the United States or of a State may register for the purposes of this title by filing with the Commission a notification of registration, in such

[9] 54 Stat. 802; 15 U. S. C. 80a-7(a).
[10] 54 Stat. 803; 15 U. S. C. 80a-8.

form as the Commission shall by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. An investment company shall be deemed to be registered upon receipt by the Commission of such notification of registration.

* * * * *

Sec. 27. (a)[11] It shall be unlawful for any registered investment company issuing periodic payment plan certificates, or for any depositor of or underwriter for such company, to sell any such certificate if—

(1) the sales load on such certificate exceeds 9 per centum of the total payments to be made thereon;

(2) more than one-half of any of the first twelve monthly payments thereon, or their equivalent, is deducted for sales load;

* * * * *

McCARRAN-FERGUSON ACT

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled. That the Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

Sec. 2. (a)[12] The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State

[11] 54 Stat. 829; 15 U. S. C. 80a-27(a)(1) and 15 U. S. C. 80a-27(a)(2).
[12] 59 Stat. 33, as amended; 15 U. S. C. §§ 1011-1015.

for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

Sec. 3. (a) Until June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, and the Act of June 19, 1936, known as the Robinson-Patman Antidiscrimination Act, shall not apply to the business of insurance or to acts in the conduct thereof.

(b) Nothing contained in this Act shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.

Sec. 4. Nothing contained in this Act shall be construed to affect in any manner the application to the business of insurance of the Act of July 5, 1935, as amended, known as the National Labor Relations Act, or the Act of June 25, 1938, as amended, known as the Fair Labor Standards Act of 1938, or the Act of June 5, 1920, known as the Merchant Marine Act, 1920.

Sec. 5. As used in this Act, the term "State" includes the several States, Alaska, Hawaii, Puerto Rico, Guam, and the District of Columbia.

APPENDIX B

Legislation Which Would Have Authorized Sale of Variable Annuities to Public

State	*Year*	*Bill*	*Disposition*
Connecticut	1957	House 1427—to incorporate the Equity Life Insurance Company.	Joint Hearing March 21, 1957. Referred by House Joint Resolution 170 to Legislative Council for study.
Maryland	1955	House 597—to incorporate the Variable Life Income Corporation of Maryland.	No action.
		House 730—to provide for the establishment and operation by Life Insurance Corporations of a variable contract account, etc.	Passed House. Died in Senate Committee.
Massachusetts	1956	House 1560—to authorize life insurance companies to establish variable contract accounts, etc.	Joint Hearing February 6, 1956. No transcript was made. Referred to Special Commission for study by House 2716. Special Commission held public hearings on April 30 and May 1, 1957 to consider House 1560. No transcript of these hearings was made but the Special Commission issued its report covering these hearings on December 2, 1957 as Massachusetts Senate Document 556 of 1958. In this report the Commission recommended further study, looking toward affirmative legislation authorizing the issuance of annuities based upon some portion of equity investment. The Special Commission held another public hearing on May 28, 1958 to discuss, among other things, variable annuities. Speakers were requested to confine their remarks to developments on the subject since the hearing approximately one year before. No transcript was made. The Special Commission issued its report dated July, 1958 as Senate Document 815. The Special Commission reported, without recommendation, a variable annuity bill as Appendix B to its report (S. 815).

State	Year	Bill	Disposition
	1958	Senate 815 App. B—to authorize life insurance companies to establish variable annuity accounts.	Referred to Special Commission for study by Senate 842. This bill was the subject of a public hearing by the Massachusetts Joint Insurance Committee on September 29, 1958. No transcript of this hearing is available.
New Hampshire	1955	Senate 69—to authorize life insurance companies to establish variable contract accounts.	Killed in Senate on March 24, 1955 after hearing before the Senate Committee on Banks and Insurance.
New Jersey	1955	Assembly 305, 306, 307.	Public hearing before the Assembly Committee on Business Affairs May 13, 1955. Transcript available. Died in Assembly Committee.
	1956	Assembly 450, 451, 452.	Public hearing before the Senate Committee on Business Affairs June 22, 1956. Transcript available. Passed Assembly; died in Senate Committee.
	1957	Assembly 11, 12, 13.	Passed Assembly; died in Senate Committee.
	1958	Assembly 330, 331, 332.	Public hearing on May 2, 1958 before the Assembly Committee on Business Affairs. Transcript available. Passed Assembly; in Senate Committee.
New York	1954	Assembly 1323 (Senate 2681)—to incorporate Variable Annuity Corporation of America.	Passed both houses. Vetoed by Governor Dewey.
	1955	Senate 1352 (Assembly 1657)—to incorporate Variable Life Income Corporation of America.	Passed in Assembly. Bill died in Senate Committee.
	1957	Assembly 4044—to incorporate Variable Life Income Corporation of America.	Died in Assembly Committee.
Texas	1955	Senate 332 (House 737)—providing for the formation of corporations for the purpose of issuing variable annuity contracts.	Died in Committee.

NOTE: The table appearing above summarizes only those bills which would have authorized life insurance companies, or new companies known as life insurance companies, to sell "variable annuities" to the public. It does not include pension plans, which are not insurance, and do not and could not qualify under general insurance laws, such as:

1. The College Retirement Equities Fund (CREF), sold only to college professors. By special legislation CREF was authorized to do business by the State of New York subject to regulation and control of its Insurance Commissioner under four provisions of the State's general insurance laws (An Act to Incorporate College Retirement Equities Fund for the benefit of the teaching profession, N. Y. Laws 1952, C. 124); or
2. Three bills passed by the Wisconsin Legislature in 1957 which incorporated the "variable annuity" principle into the retirement systems for state employees, state teachers and the teachers of Milwaukee on much the same basis as CREF, Wisconsin Laws 1957, Chs. 322, 381, 423; or
3. Two bills introduced in the Massachusetts legislature (S. 341 and S. 815 (both of 1958)) which are essentially "variable annuity" bills but limited to group business.